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In re Vitro: The Fifth Circuit Refuses to Sign Off on Non-Debtor Affiliate Releases

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On 28 November 2012, the United States ('US') Court of Appeals for the Fifth Circuit (the 'Court of Appeals') affirmed the much debated decision of the United States Bankruptcy Court for the Northern District of Texas (the 'Bankruptcy Court') denying recognition of the Mexican plan of reorganisation of Vitro S.A.B. de C.V. ('Vitro') approved by a Mexican court in Vitro's insolvency proceeding ('*concurso*') in Mexico.[1] The Court of Appeals also affirmed the district court's judgment recognising the Mexican reorganisation proceeding and the appointment of the foreign representatives.

Background[2]

Vitro, the largest glass manufacturer in Mexico, operates through a network of subsidiaries, including US subsidiaries. Between February 2003 and February 2007, Vitro borrowed a total of approximately USD 1.216 billion through the issuance of three series of unsecured notes (the 'Notes'). The Notes were bought predominantly by US investors (the 'Noteholders'). The Notes were guaranteed by substantially all of Vitro's subsidiaries. The guaranties were to be governed and construed under New York law and were not to be released, discharged, or otherwise affected by any settlement or release as a result of any insolvency, reorganisation, or bankruptcy proceeding affecting Vitro. After being impacted by the financial crisis, Vitro failed to make scheduled interest payments to the Notes. Vitro started restructuring its debt, and through these transactions, among other things, Vitro amassed significant intercompany indebtedness, but failed to disclose these transactions to Noteholders.

Vitro's negotiations with creditors were unsuccessful. Vitro commenced a voluntary reorganisation proceeding in Mexico, pursuant to which a *conciliador* (an appointed quasi-judicial officer with certain responsibilities in the *concurso* proceeding) was appointed.[3] On December 5, 2011, the *conciliador* submitted a plan of reorganisation (the 'Plan'). The Plan provided, among other things, that the Notes would be extinguished and the subsidiary guarantors would be discharged. Under Mexican law, a plan of reorganisation is confirmed if at least 50% of the aggregate principal amount of unsecured debt, as a single class, votes in favor of the plan. The approval of Vitro's Plan was secured by Vitro's subsidiaries, who held over half of all voting claims due to prior reshuffling of intercompany obligations.

Vitro's foreign representatives, appointed by Vitro's board of directors,[4] filed a chapter 15 petition seeking recognition as a foreign main proceeding. Over objections, the bankruptcy court recognised the Vitro's *concurso* as a foreign main proceeding and approved the petition confirming the foreign representatives. Subsequently, the foreign representatives sought court order enforcing the Plan and precluding US investors from pursuing collection from Vitro's guarantor subsidiaries (the 'Enforcement Motion'), which was denied by the Bankruptcy Court.

The Court of Appeals considered the following consolidated appeals:

Notes

1 The Court of Appeals' decision is *Ad Hoc Group of Vitro Noteholders v Vitro Sab de C.V. (In re Vitro Sab de C.V.)*, No. 12-10542, 2012 U.S. App. LEXIS 24443 (5th Cir. Nov. 28, 2012) ('*Vitro*'). An appeal raising substantially similar issues is currently pending in a Mexican appellate court.

2 *See In re Vitro S.A.B. de C.V.*, 455 B.R. 571 (Bankr. N.D. Tex. June 24, 2011); *Vitro S.A.B. de C.V. v ACP Master, Ltd. (In re Vitro)*, 2012 Bankr. LEXIS 2682 (Bankr. N.D. Tex. June 13, 2012); and *Ad Hoc Group of Vitro Noteholders v Vitro Sab de C.V. (In re Vitro Sab de C.V.)*, No. 12-10542, 2012 U.S. App. LEXIS 24443 (5th Cir. Nov. 28, 2012) for background facts.

3 In the meanwhile, US investors sought to collect on the Notes in US courts. Among other things, a New York state court ruled in favor of the indenture trustees, holding that a non-consensual release, discharge or modification of the obligations of the guarantors was not allowed, but left open the issue of whether Mexican law could trump such provision. *Wilmington Trust v Vitro Automotriz, S.A. de C.V.*, 33 Misc. 3d 1231(A), 2011 NY Slip Op 52189(U) 2011 WL 6141025, at *6 (N.Y. Sup. Ct. 2011).

4 Because the first appointed foreign representative, Alejandro Sanchez-Mujica, could not leave Mexico due to certain travel restrictions imposed on such representatives in the *concurso*, Vitro's board of directors appointed another foreign representative, Javier Archavaleta-Santos, and filed a supplemental petition to recognise him as 'co-foreign representative.' *Vitro*, at *16-17.

(i) an appeal from the district court's ruling confirming the Bankruptcy Court's decision recognising the *concurso* as foreign main proceeding and approving the chapter 15 petition confirming the foreign representatives;

(ii) a direct appeal from the Bankruptcy Court's order denying the Enforcement Motion.

Recognition of Foreign Representatives

Before a foreign proceeding is recognised under chapter 15, under section 1509 of the Bankruptcy Code, three requirements must be met:

(i) such foreign proceeding is a foreign main or foreign nonmain proceeding;

(ii) the foreign representative applying for recognition is a person or a body; and

(iii) the petition meets certain requirements regarding the documentation to be submitted with the petition for recognition.

Section 101(24) of the Bankruptcy Code defines a 'foreign representative' as a 'person or body, including a person or body appointed on an interim basis, authorised in a foreign proceeding to administer the reorganisation or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding.' The Noteholders objected to the recognition of foreign representatives, claiming that they were not property appointed because (i) they were appointed by Vitro's board of directors rather than a Mexican court, and (ii) Vitro did not have powers of a debtor in possession.

Foreign Representatives Are Not Required To Be Judicially Appointed

Concurring with the district court, the Court of Appeals held that chapter 15 did not mandate a foreign representative to be officially appointed by a court, finding that '[s]ection 101(24) ... is wholly devoid of any statement that a foreign representative must be judicially appointed ... The other provisions the Noteholders identify suffer from the same defect.'[5] The Court of Appeals agreed with the district court's analysis of Bankruptcy Code section 101(24), which concluded that it is 'sufficient for a foreign representative to be authorized in the context of a foreign bankruptcy proceeding.'[6] In addition, the Court of Appeals noted that the proper appointment of the foreign representatives was supported by the Mexican court, which did not enjoin their conduct and refused to declare the *conciliador* (who also agreed to the appointment of the foreign representatives) to be the only person authorised to act as foreign representative.[7]

For Purposes of Chapter 15, a Debtor in Possession Must Meet the Definition Envisioned by the Model Law Rather than the Chapter 11 Definition

On appeal, the district court held that Vitro held sufficient control over its business to be deemed a debtor in possession, and that their authorisation to act as foreign representatives in the *concurso* sufficed to recognise them as foreign representatives in the chapter 15 case. The Court of Appeals concluded that the definition of foreign representative intended to include a debtor in possession, which, however, was modelled after the Model Law,[8] rather than the US definition contained in chapter 11 of the Bankruptcy Code, and included debtors that retain 'full control over the business, with the consequence that the court does not appoint and insolvency representative.'[9] The Court of Appeals found that Vitro's control over its affairs fit squarely into this definition, and, therefore, found the appointment of foreign representatives to be proper.

Enforcement of the Plan

The Plan restructured Vitro's debt and *de facto* discharged Vitro's non-debtor subsidiary guarantors.[10] The Enforcement Motion sought an order pursuant to sections 105(a), 1507 and 1521 of the Bankruptcy Code giving the Plan full force and effect in the US and put a stop to actions against Vitro and its non-debtor subsidiaries in the US by way of a permanent injunction.

Notes

5 *Vitro*, at *35.
6 *Id.*, at *32, citing *In re Vitro, S.A.B. de C.V.,* 470 B.R. 408, 411-413 (N.D. Tex. 2012).
7 *Id.* at *38.
8 Model Law on Cross-Border Insolvency, promulgated by the United Nations Commission on International Trade Law at its Thirtieth Session on May 12-30, 1997, UN Sales No. E.99V.3, 1999.
9 UNCITRAL, Practice Guide on Cross-Border Insolvency Cooperation 5 (July 1, 2009), available at <www.uncitral.org/pdf/english/texts/insolven/Practice_Guide_Ebook_eng.pdf>.
10 The Plan also provided for an apparent violation of the absolute priority rule by allowing equity to retain a value of about USD 500 million, while creditors were not paid in full.

The appellants underpinned the many issues raised before the Bankruptcy Court[11] by asking the Court of Appeals to determine whether the Bankruptcy Court erred in finding that the order approving the Plan, being a result of a process that was not unfair or corrupt, should not be enforced solely because the Plan novated guarantee obligations of non-debtor subsidiaries and replaced them with new obligations of substantially the same parties.[12]

Releases to Non-Debtor Guarantors are Not Available Under Either Section 1521 or Section 1507 of the Bankruptcy Code

In analysing relief available under sections 1507 and 1521 of the Bankruptcy Code, the Court of Appeals developed the following framework:

(i) courts should initially consider whether the relief requested falls within explicit forms of relief provided in Bankruptcy Code section 1521;

(ii) if the relief requested is not expressly available under section 1521, courts should consider whether it could be deemed 'appropriate' under section 1521(a) of the Bankruptcy Code,[13] which requires analysing whether such relief has previously been provided under the repealed Bankruptcy Code section 304;

(iii) only if the relief appears to fall outside of the scope of section 304 or other relief allowed under current US law, should the court consider section 1507 of the Bankruptcy Code.

By applying this framework to relief requested in the Enforcement Motion, the Court of Appeals concluded that discharging obligations of non-debtor guarantors did not meet any relief enumerated under section 1521, as (i) none of the forms available allowed the relief sought, and (ii) a non-consensual, non-debtor release does not fall within 'appropriate relief'. Nor could such relief be allowed under section 1507. Even though it is the purpose of section 1507 of the Bankruptcy Code to provide relief not otherwise available under US law (the Court of Appeals acknowledged that section 1507 *theoretically* provides for relief sought by Vitro and that other circuits may allow non-consensual, non-debtor discharges), the Court of Appeals held that the Bankruptcy Court did not abuse its discretion in denying the Enforcement Motion because Vitro failed to prove 'comparable extraordinary circumstances that would make enforcement of such plan possible in the United States ….'[14] The absence of such circumstances prompted the Court of Appeals to agree with the Bankruptcy Court that comity should not be granted and the Plan should not be enforced.[15]

In distinguishing cases allowing non-debtor releases, the Court of Appeals noted, for instance, that releases were granted where such releases were almost unanimously approved by creditors (*In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010)), or where such releases were specific (*Republic Supply Co. v Shoaf*, 815 F.2d 1046 (5th Cir. 1987)) rather than general, as in Vitro's Plan. To the contrary, comparable extraordinary circumstances could not be found where Vitro's Plan allowed equity to retain substantial value, while creditors were not paid in full. Moreover, objecting creditors were grouped into a voting class with insiders, and did not vote in favour of the Plan or were given an alternative for recovery. The Court of Appeals noted that allowing Vitro to rely on insiders holding the majority of voting power to confirm its Plan 'would amount to letting one discrepancy between our law and that of Mexico (approval of a reorganization plan by insider votes over the objections of creditors) make up for another (the discharge of non-debtor guarantors).'[16]

While concluding that the Bankruptcy Court's decision was reasonable in denying enforcement of the Plan, the Court of Appeals disagreed with the Bankruptcy Court's interpretation of the public policy exception embedded in section 1506 of the Bankruptcy Code.[17] The Court of Appeals noted that the Bankruptcy Court's 'broad description' of the fundamental policy at issue as 'the protection of third party claims in a bankruptcy case' did not follow the intent of the public

Notes

11 For discussion of the issues considered by the bankruptcy court in *Vitro S.A.B. de C.V. v ACP Master, Ltd. (In re Vitro)*, 2012 Bankr. LEXIS 2682 (Bankr. N.D. Tex. June 13, 2012), *see also* Maja Zerjal, *In re Vitro: Comity Should Not Be Taken For Granted – The Public Policy Exception is Alive and Well*, 9 INT'L CORP. RESCUE 380 (2012).

12 *Vitro*, at *53.

13 'Upon recognition … the court may, at the request of the foreign representative, grant *any appropriate relief*, including ….' 11 U.S.C. § 1521(a) (emphasis added).

14 *Id.* at *77.

15 The objecting Noteholders argued that comity should not be granted, because the Mexican Court denied comity to a New York court when it failed, in the process of approving the Plan, to even address the prior declaratory judgment opinion of the New York state court regarding the subsidiaries' guaranties. The Court of Appeals found that reciprocity was not offended, because the New York court did not rule on whether the indentures precluded Mexican law from novating the obligations under the guaranties. *Id.* at *90.

16 *Id.* at *97-98.

17 Section 1506 of the Bankruptcy Code provides for a public policy exception, which allows courts to refuse to take an action under chapter 15 if such action would be manifestly contrary to the public policy of the US.

policy exception, which is to be construed narrowly. However, as the Court of Appeals established that the inapplicability of either Bankruptcy Code 1521 or 1507 was sufficient to deny the relief request, it refused to rule on whether the Plan was manifestly contrary to any fundamental public policy of the US.

Conclusion

Despite avoiding a discussion on the applicability and scope of the public policy exception, the decision of the Court of Appeals sets a strong precedence for foreign debtors seeking to enforce non-debtor releases in the US *via* chapter 15. The Court of Appeals did concede that other circuits may disagree that the Bankruptcy Code precludes non-consensual, non-debtor releases, but it seems unlikely that the circumstances in which Vitro's Plan was confirmed would lead any other US court to allow such releases. Indeed, following a series of 'controversial' issues related to the Plan, Vitro's affiliates sought to evade collections by US creditors and failed to disclose such actions to the courts. In a recent decision determining whether to grant creditors' involuntary petitions against ten Vitro's affiliates, Judge Harlin Hale found such nondisclosure to be 'particularly disturbing', and ordered that the affiliates be put into involuntary bankruptcy.[18] The decision marks another victory for Vitro's US investors.

Notes

18 *In re Vitro Asset Corp., et al.*, Case No. 11-32600-hdh-11, Docket No. 1574 (Bankr. N.D. Tex. Dec. 4, 2012).

Re Kaupthing Singer & Friedlander Ltd (in administration) [2012] EWHC 2235 (Ch)

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Summary

The High Court of England and Wales has held that the moratorium on proceedings against companies in administration in England under paragraph 43, Schedule B1 of the Insolvency Act 1986 has extra-territorial effect when the company in administration is a UK credit institution subject to the Credit Institutions (Reorganisation and Winding Up) Regulations 2004 (SI 2004/1045).

Background

European council directive on the reorganisation and winding up of credit institutions (2001/24/EC) (the 'Directive') provides that insolvency proceedings commenced with respect to a credit institution incorporated in an European Economic Area member state (a 'Member State') should be recognised without further formalities between the courts of the relevant Member States. The Directive is implemented in the UK by Credit Institutions (Reorganisation and Winding Up) Regulations 2004 (SI 2004/1045) (the 'CIR') and in Iceland by the Financial Undertakings Act No. 161/2002.

Facts

Kaupthing HF ('KHF') was a company incorporated in Iceland. KHF was the holding company of the English incorporated Kaupthing Singer & Friedlander Ltd ('KSF'). In 2004, KHF issued EUR 4,500,000,000 bonds (the 'Bonds'). The Bonds were governed by English law and the terms provided KHF with an option to repurchase Bonds prior to their final maturity date. In May 2008, KHF and KSF entered into two transactions (the 'Transactions') pursuant to which KHF purchased (a) EUR 5,000,000 Bonds for EUR 4,409,369 from KFS; and (b) EUR 5,000,000 Bonds for EUR 4,313,316 from KFS.

On 8 October 2008, KSF went into bank administration in the UK. KHF was placed into Icelandic liquidation by an order of the District Court of Reykjavik made on 22 November 2010 with a reference date of 15 November 2008.

KSF and KFH are both credit institutions incorporated in Member States for the purposes of the Directive.

The liquidators of KHF considered that the payments made by KHF to KSF pursuant to the Transactions should be 'rescinded' and repaid to KHF pursuant to ss134 and 142 of the Icelandic Bankruptcy Act No. 21/1991 (the 'IBA').

KHF had previously made an application to the English court for permission to commence proceedings against KSF (which was in administration in the UK) in both Iceland and the UK. Arnold J. in the English court granted the liquidators of KHF with permission to commence proceedings in Iceland, and bring a parallel claim in the UK by an order dated 15 June 2012. These permissions were limited to the commencement of proceedings only.

KHF subsequently commenced proceedings against KSF in Iceland and the UK.

Issues

KHF and the administrators of KSF sought various permissions and directions from the English court in relation to potential clawback of the amounts paid by KHF to KSF pursuant to the Transactions.

In particular, the High Court was asked to consider two primary issues.

1. Whether, if KHF was successful in either the Icelandic or UK claims which it had commenced, it would be entitled to prove in the administration of KSF for any judgment amount received in relation to a rescission of the Transactions (the 'Provable Debt Application'); and
2. Whether KHF should be granted permission to continue its claims against KSF in either Iceland or the UK for recovery of payments made by KHF to KSF pursuant to the Transactions (the 'Permission Application').

Decision

Sir Andrew Morritt sitting in the High Court of England and Wales held as follows.

1. Neither the claims made by KHF in Iceland nor any similar claims made in England would, if successful, give rise to a provable debt in the administration of KSF in England.
2. KHF did require the permission of the English court to continue proceedings in either Iceland or the UK against KSF.
3. Permission to continue proceedings in the UK was denied on the basis that the claim could not give rise to a provable debt in the administration of KSF.
4. Permission to continue the proceedings in Iceland was granted, as a refusal would be an unwarranted intrusion into matters properly to be left to the Icelandic courts. However, the permission was granted on the condition that KHF would not seek to enforce any judgment which it may receive against KSF in Icelandic proceedings in the UK, other than by way of set-off of the judgment amount against any other amounts which it owed to KSF.

Reasoning and issues considered

The provable debt application

In order to provide judgment on the Provable Debt Application, the English court was required to consider whether, if successful in proceedings in either England or Iceland, any entitlement of KHF to payment from KSF, would constitute a provable debt in the administration of KSF within Rule 13.12(1) of the Insolvency Rules 1986 (the 'Rules').

Rule 13.12(1) as relevant at the time KSF went into administration on 8 October 2008, provides that:

> '(1) "Debt" in relation to the winding up of a company, means (subject to the next paragraph) any of the following:
>
> (a) any debt or liability to which the company is subject at the date on which it goes into liquidation;
>
> (b) any debt or liability to which the company may become subject after that date by reason of any obligation incurred before that date; and
>
> (c) ...'

Each party agreed that any obligation which KSF may have to repay KHF monies which it received under the Transaction pursuant to a successful clawback claim by KHF, could not constitute a provable debt for the purposes of Rule 13.12(1)(a). The question was whether any such obligation of KSF constituted a 'Debt' of KSF within Rule 13.12(1)(b) at the time when KSF went into administration on 8 October 2008. This would depend on whether, at that time, KSF had incurred an obligation to KHF in relation to the payments it received pursuant to the Transactions. In order to answer this question, the judge considered (a) the nature of the rights which KHF was seeking to rely on for rescission and repayment under ss 134 and 142 IBA; and (b) English law authorities on the meaning of Rule 13.12(1)(b).

It was held that the provisions of ss 134 and 142 IBA did not apply to the Transactions, as KHF could not show, as was required by these IBA provisions, that the insolvency of KHF was 'either in prospect or objectively likely'. Given this, KHF did not have, as at 8 October 2008, any basis to seek repayment of payments it had made to KSF under Articles 134 and 142 IBA. In addition, none of the English law cases required the English court to recognise an obligation of KSF existing on 8 October 2008 dependant on the future winding up of KHF in Iceland.

Accordingly, the English court held that a successful claim for KHF for rescission of payments which it made to KSF under the Transactions could not constitute a provable debt under Rule 13.12(1) in the administration of KSF.

The permission application

In providing its judgment on the Permission Application the English court considered the following.

Article 10(e) of the Directive provides that the effects of winding up proceedings on proceedings brought by individual creditors of KSF are governed by English law. Article 10(e) is implemented in the UK by Regulation 22(3) of the CIR. Regulation 22(2) and (3) CIR provide that the effects of the relevant winding up on proceedings brought by creditors are to be determined in accordance with the 'general law of insolvency of the United Kingdom'.

Paragraph 43, Schedule B1 IA 1986 imposes a moratorium on actions against a company in an English administration, and provides specifically that no legal proceedings may be commenced against a company in administration except with (a) the consent of the administrator; or (b) the permission of the English court.

As such, on the face of it, the effect of Regulations 22(2) and (3) CIR is that the protections provided by the moratorium set out at para. 43, Schedule B1, IA 1986 (which is a provision of the 'general law of insolvency of the United Kingdom') to English companies in administration, would apply to KSF.

Counsel for KHF argued that case law which considers the applicability of the sections of the IA 1986 (including paragraph 43, Schedule B1, IA 1986) would also constitute the 'general insolvency law of the UK'. The court did not disagree with this. KHF's counsel went on to argue that previous English law cases, in particular the case of *Harms Offshore AHT Taurus GmbH & Co Kg v Bloom and others* [2009] EWCA Civ 632 provided authority that the moratorium prohibiting proceedings

being brought against an English company in administration did not apply to non-UK proceedings brought against that company. KHF argued that on this basis, it did not require the permission of the English court (or the permission of the administrator of KSF) to continue the clawback proceedings in Iceland.

The English court did not deny that that English case law formed part of the 'general law of insolvency in the United Kingdom'. However, the English court did not accept KHF's argument. The judge stated that the *Harms Offshore* case did not concern a company which was a credit institution, and that the general law of insolvency to which Regulation 22(2) relates cannot apply to a credit institution which is subject to the CIR as a whole. KSF was a credit institution subject to the CIR and the English court held that in this context the moratorium imposed on proceedings against KSF by para 43, Schedule B1 IA 1986 did have effect in Iceland. As such, the English court held that permission of either the English court or the administrator of KSF would be required for KHF to continue its proceedings in either Iceland or the UK.

It was held that, as KHF did not have a provable debt in KSF's administration in the UK, there was no reason to grant permission to KHF to continue proceedings in the UK. However, as there was the potential for KHF to seek to set-off any judgment amount received pursuant to successful claim in Iceland against amounts which it may owe to KSF, denying permission to continue the Icelandic claims would 'constitute an unwarranted intrusion into the matters properly to be left to the Icelandic courts dealing with the liquidation of KHF'.

However, the English court was concerned that it should protect the assets and creditors interested in the administration of KSF. In order to achieve this, the permission to continue the Icelandic proceedings was provided to KHF on the condition that it would not seek to enforce a successful judgment against KSF, either as a provable debt or otherwise, other than by way of setting off any judgment amount against amounts which it may owe to KSF.

Unwarranted Attention

Christopher Brockman, Barrister, Guildhall Chambers, and **Crispin Daly**, Associate, Proskauer Rose LLP, London, UK

The case

Autoquake Limited v Car Care Plan Limited [2012] EWHC 1344 (Ch) is a case of interest to practitioners in relation to the administration of a retail company with a large number of potential contingent consumer creditors, in this case holders of warranties purchased along with second hand motor vehicles. Although very fact specific, as in all cases of this nature, it provides a useful insight into a number of issues that can arise in the course of an administration and how the Companies Court (at both Registrar and Judge level) are likely to view those issues and assist an office holder in carrying out his functions.

Background

Autoquake Limited ('Autoquake') was incorporated on 17 August 2005 as an online car retailer. It only sold motor vehicles via its website and did not have a physical car show room. Cars were collected by purchasers from designated collection centres in London and Leeds. Although never profitable it nonetheless sold approximately 1,000 vehicles per month.

For this purpose it had a wholly owned e-commerce internet-based platform specifically designed to facilitate and support the sale of motor vehicles via the internet. When a car was sold it also sold warranties and breakdown cover to the purchasers of vehicles.

Autoquake entered administration on 17 March 2011 on which date there were approximately 5,600 unexpired warranties with various periods left to run, from a few days to approaching three years. The warranty scheme was not an insurance scheme (or insured in any way) but was meant to be self funded by Autoquake by means of a contribution into a designated fund which was administered on its behalf by an independent scheme administrator.

The warranty scheme

The details of warranty were contained in the Autoquake warranty handbook (the 'Handbook') which made reference to (but did not set out) the provisions of the Motor Industry Code of Practice for Vehicle Warranty Products (the 'Motor Code'), stating that 'This product conforms to the Motor Industry Code of Practice for Vehicle Warranty Products'.

The Motor Code to which the independent administrator ('the Warranty Administrator') was a subscriber and which was available to all the purchasers of cars from Autoquake on the internet and stated:

'– The product literature will clearly state that the product is a non-insured product.

– Claim funds are protected by a trust, statutory trust to protect claims funds for the payment of claims. The product literature will clearly state that a protected claims fund is in place.

– In the event that a retailer ceases to trade, we will continue to pay all claims from the protected claims fund, as long as funds remain in place.

– The exact nature of how a claims fund is protected is available from us upon request.'

The scheme was governed by a separate contract between Autoquake and the Warranty Administrator (the 'Contract') which operated as follows:

– Autoquake would sell the warranty in the form provided to it by the Warranty Administrator and register the warranty with the Warranty Administrator when sold;

– The Warranty Administrator would invoice Autoquake on a weekly basis for an amount made up of an agreed contribution to a claims fund for each warranty sold and administration fee plus VAT;

– On a monthly basis the Warranty Administrator would produce a statement setting out the current level of the claims fund taking into account the amount of money paid out in respect of any claim and the amount paid into it by Autoquake;

– Depending upon the outcome of that exercise there would be a payment to Autoquake of any surplus or a payment the other way if there was a shortfall;

– The claims fund was to be reviewed after 6 months and subsequently on a regular basis.

Termination of the warranty scheme

At the date of the administration the Warranty Administrator held approximately GBP 310,000. The Contract was terminated by mutual agreement on 22 March 2011 and by April the Warranty Administrator had transferred the money to the Joint Administrators.

The Joint Administrators wrote to the warranty holders informing them of the administration and that Autoquake was unable to make any payment under any warranty or other product sold. The Joint Administrators invited them to provide details of any claim that arose during the administration and provided a proof of debt form.

The claims of the warranty holders

At the time of the administration potentially 5,600 creditors with an unexpired warranty (the 'Warranty Holders') were identified with potential claims totalling an estimated GBP 1,683,063. In the light of the level of secured debt it was clear from the very beginning that the only possible distribution to unsecured creditors would be from the prescribed part pursuant to section 176A (2) of the Insolvency Act 1986 with the total payable estimated at about GBP 430,000.

If the Warranty Holders were to be included, the distribution to unsecured creditors would have been (after costs) 0.88 pence in the pound at best. Without the Warranty Holders the level of distribution might have been be as high as 3 pence in the pound.

The Joint Administrators therefore had to consider whether to make an application to the Court to disapply the prescribed part pursuant to section 176A (5) of the Insolvency Act 1986 on the basis that it would be uneconomic to make a distribution to unsecured creditors if the Warranty Holders were to be included. In order to determine this effectively the Joint Administrators needed to be able to value the claims of the Warranty Holders. Such a valuation was difficult given that the unexpired terms of the warranties in some cases ran to three more years.

The Joint Administrators decided that the fairest way to value the Warranty Holder claims was to value them according to the amount paid and the remaining period of each unexpired warranty. The Warranty Holders would then be permitted to prove in the administration for this amount. It was also decided that a cut-off point was needed and the Joint Administrators decided to write to all of the Warranty Holders giving them a finite period (28 days) in which to lodge proofs of debt in the administration, after which they would be barred from doing so.

As this was an unusual situation and would mean that some of the Warranty Holders would be disadvantaged, in that they would not be able to prove for the costs of any repairs after the cut off date, the Joint Administrators applied to the Court for directions approving the proposed course of action.

The potential trust

The Warranty Administrator wrote to the Joint Administrators on 13 March 2011 informing them that they had received a number of complaints and asserting that the funds were supposed to have been held on trust as provided for in the Motor Code which was referred to in the Handbook given to Warranty Holders by the Company.

The Joint Administrators formed the view that the proceeds of sale of the warranties were paid into the Company's general bank account and that despite the statement in the Handbook there had been no intention to create a trust over those monies. Nonetheless, given the number of consumers involved, the Joint Administrators decided to seek the Court's directions in this respect.

The first hearing before the Registrar

The Joint Administrators applied to court for the following directions:

- Whether a trust had been created;
- How claims of the Warranty Holders were to be valued for distribution purposes; and
- That the court would impose a 28 day notice period to Warranty Holders, which would be followed by a bar to bring any claim.

At the first hearing on 3 November 2011 Registrar Barber adjourned the matter because she was concerned about the possible existence of a trust and made provision for the Warranty Holders to be represented directing the Joint Administrators to seek a representative party to argue the case on their behalf.

Change of circumstances and second hearing before the Registrar

After the first hearing the Warranty Administrator unexpectedly offered, that in return for being admitted as a creditor in the sum of GBP 40,000 it would continue to meet the claims of Warranty Holders up to the approximate amount GBP 351,000 being the fund held by them at the date of the Company's administration.

This changed the basis of the application away from how to value the claims of the Warranty Holders to whether they should be admitted at all – given that they were in effect getting what they paid for from another source.

Registrar Derrett heard an expedited amendment application, suspended the directions from the first hearing and ordered the matter to be heard before a judge.

The first hearing before the Judge

On 18 January 2012 the Joint Administrators sought the following directions:

- Whether the funds were held on trust;
- How to treat the Warranty Holders as creditors in the administration and, in the light of the change of circumstances, whether they were to remain creditors in the administration;
- To admit the Warranty Administrator as an unsecured creditor in the administration so that they might participate in the distribution (if any) of the prescribed part; and
- If the Warranty Holders were to be admitted as unsecured creditors, how they should be valued.

Mr Justice Mann held that there was not a trust and that the Joint Administrators were at liberty to distribute the funds they had received from the Warranty Administrator.

The Joint Administrators argued that it was possible to value the Warranty Holders claims in the administration at zero as the Joint Administrators had contended, on the basis that the Warranty Holders would receive up to GBP 351,000 by claiming against the Warranty Administrators and that there would be potential double recovery.

Mann J was not prepared to do this, expressing concern that the ability of the Warranty Administrator to pay Warranty Holders' claims was dependent on:

- the Warranty Administrator undertaking to continue to pay out Warranty Holder claims up to the value of approximately GBP 351,000; and
- the Warranty Administrator being in a financial position to continue to pay over the three year period of unexpired warranties.

Mann J adjourned the hearing for a period to gather evidence as to the Warranty Administrator's intentions, financial strength and the total potential value of all Warranty Holder claims. He ordered that no distribution was to take place until after the adjourned hearing (or such other date as the court may order) at which the Court would give directions as to:

- the admission of the warranty holders as creditors or otherwise;
- the method of notifying the warranty holders of the decision of the court; and
- the mechanism to enable any warranty holder to seek a review of the court order and any further order made at the adjourned hearing.

The adjourned hearing

Although the Warranty Administrator had written to the Joint Administrators on 22 February 2012 with the requested undertaking to continue to pay out Warranty Holder claims up to the value of approximately GBP 351,000 and had enclosed its audited accounts to 31 December 2012, the Judge, Sarah Asplin QC (as she then was), would not value the Warranty Holder claims at zero. She was concerned that, even assuming that the Warranty Administrator intended and was able to continue to pay out claims there was no certainty, on the balance of probabilities, that the sum of GBP 351,000 would be sufficient to cover all claims made under the warranties in the future. In particular she noted that it was likely that the number of claims would increase towards the end of the warranty expiry dates.

Nonetheless the Judge recognised that it was not in the best interests of creditors to keep the administration open until the warranties had expired and held that a bar date for the Warranty Holders to prove in the administration was an efficient and cost effective means to allow the administration to be concluded in a reasonable time. The Judge did, however, extend the cut off period of 28 days to 42 to allow Warranty Holders to both prove in the administration and to seek to set aside or challenge the ruling by Mann J in relation to the trust position.

She declined to admit the Warranty Administrator (who was not represented) as an unsecured creditor on the basis that its actions in paying Warranty Holders were voluntary and the decision to do so was taken without reference to the Joint Administrators.

Conclusions

Although the trust argument turned out to be a red herring once raised it was necessary from the Joint Administrators' point of view to seek directions; not least because of the number of consumer creditors who would had potential claims against the fund and had no effective representation.

The Court in seeking to find a method by which the Warranty Holders could be represented showed that in cases where there are a large number of creditors it will do what it can to give those creditors a voice and the opportunity to make representations to the Court; although in this case that ultimately turned out to be unnecessary and it will always be difficult, where there are a large number of creditors who will receive a small

dividend, to find one willing and able to spend the time and money to represent a class.

One of the questions for the Court was whether it has the ability to exclude possible future clams whether by valuing them at nil or otherwise. This does not seem to have been addressed before in respect of creditors in an administration.

A court will give directions in a creditors' voluntary liquidation the consequences of which are to exclude possible future claims: *Re Armstrong Whitworth Securities Limited [1947] 1 Ch 673*. Similarly in *R-R Realisations Limited [1980] 1WLR 805* the Court made an order the result of which was to exclude potential negligence claims against Rolls Royce following a crash as a result of the failure of an aircraft engine.

In the Woolworth administration *(WW Realisations [2010] EHCH 3604 Ch)* Mr Justice David Richards was asked to approve a scheme the result of which would have been to exclude landlords and local authorities from claiming as expense creditors for rent and/or rates in the administration of Woolworths. In doing so he stated-

> '23. Mr Moss, who appears for the administrators with Mr Bayfield, tells me that he is not aware of a case in which the court has given such a direction in respect of administration expenses.
>
> 22. The jurisdiction is well founded in relation to claims in liquidations. It is sufficient for these purposes simply to refer to Re Armstrong Whitworth Securities Company Limited [1947] Ch 673, where, having considered very fully the matter and in the light of argument from interested parties, Jenkins J made a detailed order providing for distribution to members without providing for claims except for those lodged by a particular date. The terms of the order are set out in full at pp. 694-5. The jurisdiction, which had no doubt been exercised before that decision, has been exercised on many occasions since then, and is discussed in the judgment of Megarry J in Re RR Realisations Limited [1980] WLR 325.
>
> 23. The jurisdiction is derived so far as liquidations are concerned, from the statutory power of the court to give directions to liquidators, now contained in s.168(3) of the Insolvency Act 1986. The equivalent power to give directions to administrators is contained in paragraph 63 of Schedule B1 to the Insolvency Act, and I can see no reason why it should not be exercised in a similar way. Equally, I see no reason why it should not be exercised in relation to expense claims, as well as provable debts.'

The Autoquake decision is an example of this final point and demonstrates that the Court will do what it can to assist office holders where there are large numbers of creditors and it is uneconomic to continue an administration to enable claims to crystallise.

NML Capital Ltd v The Republic of Argentina

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In *NML Capital, Ltd. v The Republic of Argentina*,[1] the United States Court of Appeals for the Second Circuit affirmed two critically important holdings relating to the United States' role in the sovereign debt market. First, the Second Circuit affirmed the district court's interpretation of a fiscal agency agreement that enforced a non-subordination provision prohibiting Argentina from paying subsequent restructured debt issuances ahead of the original notes, despite the enactment of laws in Argentina prohibiting payment of the original notes. Second, cognisant that its ruling may be a pyrrhic victory since enforcement of its judgment in Argentina would be unlikely, the Second Circuit affirmed specific performance but remanded that part of the decision back to the district court to determine how to require bank intermediaries to comply with the court's directives.

I. Background

The litigations underlying the *NML* decision stemmed from Argentina's 2001 default on certain bonds, Argentina's subsequent actions in an attempt to restructure its foreign debt, and its alleged failure to give effect to a *pari passu* clause contained in its original indebtedness.

In 1994 Argentina issued a number of debt securities ('FAA Bonds') under a Fiscal Agency Agreement ('FAA'), which contained a so-called *pari passu* clause. In 2001 Argentina defaulted on the FAA Bonds and the President of Argentina declared a 'temporary moratorium' on principal and interest payments on the nation's external indebtedness, including the FAA Bonds.[2] Since its default in 2001, Argentina has not made any payments on principal or interest under the FAA Bonds to bondholders.

Argentina attempted to restructure its debt in 2005 and 2010. In 2005, Argentina offered FAA bondholders the ability to exchange their FAA Bonds for new unsecured and unsubordinated bonds at a rate of 25 to 29 cents on the dollar (the '2005 Bonds'). Argentina subsequently took several actions in an attempt to pressure FAA bondholders to participate in the 2005 exchange. First, the prospectus for the 2005 Bonds disclosed that FAA Bonds would remain in default 'indefinitely' and that the government had 'no intention of resuming payment on any of the bonds eligible to participate in [the] exchange offer.'[3] Second, Argentina's legislature passed Law 26,017, known as the 'Lock Law.' The Lock Law (i) prohibited the government from reopening any additional exchanges for FAA Bonds after the 2005 exchange was complete; (ii) prohibited the government from 'conducting any type of in-court, out-of-court or private settlement' in connection with the FAA Bonds; and (iii) required the government to remove the FAA Bonds from listing on all domestic and foreign markets and exchanges.[4] Courts in Argentina have relied on the Lock Law to refuse recognition of foreign judgments related to the FAA Bonds.

Approximately 76% of the FAA bondholders participated in the 2005 exchange.

In 2010, Argentina conducted another exchange of FAA Bonds. In order to conduct this second exchange, Argentina temporarily suspended the Lock Law. Argentina then offered an exchange of FAA Bonds for new unsecured and unsubordinated bonds (the '2010 Bonds' and, together with the 2005 Bonds, the 'Exchange Bonds') on substantially similar payment terms as the 2005 Bonds. In another attempt to pressure FAA bondholders to participate in the 2010 exchange, the prospectus contained a similar disclosure on Argentina's intentions to keep the FAA Bonds in default and further disclosed that Argentina would oppose any litigation attempting to collect under the FAA Bonds.

In total, approximately 91% of the FAA bondholders participated in either the 2005 or 2010 exchanges. Although Argentina had not made any payments to holders of the FAA Bonds since the 2001 default, Argentina had made all payments due on the Exchange Bonds. From 2009 to 2011, holders of the unexchanged defaulted FAA Bonds successfully sued

Notes

1 699 F.3d 246 (2d Cir. 2012).
2 *Id.*
3 *Id.* at 252.
4 *Id.*

Argentina on various grounds, including breach of contract and specific performance under the FAA, but none were honoured by the Argentine Courts.[5]

II. The District Court proceedings

In December 2011, the United States District Court for the Southern District of New York granted the plaintiffs' motion for partial summary judgment. The district court held that Argentina violated the *pari passu* clause by (i) making payments under the Exchange Bonds while refusing to make payments due under the FAA Bonds, and (ii) enacting the Lock Law and the subsequent suspension of the Lock Law to permit the 2010 exchange. The district court granted the plaintiffs' request for injunctive relief, ordering 'whenever [Argentina] pays any amount due under the terms of the [Exchange] bonds,' it must 'concurrently or in advance' pay plaintiffs the same fraction of the amount due to them, as determined by a set formula (the 'Ratable Payment').[6] Specifically, the Ratable Payment 'shall be an amount equal to the "Payment Percentage" multiplied by the total amount currently due to [plaintiffs] in respect of the bonds at issue in these cases.'[7] The district court defined the term 'Payment Percentage' as 'the fraction calculated by dividing the amount actually paid or which [Argentina] intends to pay under the terms of the Exchange Bonds by the total amount then due under the terms of the Exchange Bonds.'[8]

In addition to ordering the Ratable Payment, the district court's injunction (i) prohibited Argentina's agents from aiding and abetting any further violation of the FAA; and (ii) prohibited Argentina from altering or modifying its method of paying under the Exchange Bonds.[9] The district court further ordered copies of the injunction to be sent to 'all parties involved, directly or indirectly, in advising upon, preparing, processing, or facilitating any payment on the Exchange Bonds.'[10]

Argentina appealed. The Second Circuit upheld the district court's ruling that Argentina violated the *pari passu* clause and upheld the injunctive relief. However, the Second Circuit remanded to the district court to determine, among other things, the injunctions applied to third parties and intermediary banks.

III. The Second Circuit's decision

A. *Interpretation of the* pari passu *clause*

The Second Circuit viewed the analysis of the '*pari passu*' clause to be a 'simple question of contract interpretation.'[11] The *pari passu* clause provided that:

> '[t]he Securities will constitute ... direct, unconditional, unsecured and unsubordinated obligations of [Argentina] and shall at all times rank *pari passu* without any preference among themselves. The payment obligations of [Argentina] under the securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness.'[12]

The Second Circuit rejected Argentina's argument that the clause represented a boilerplate provision which was 'universally understood' to prevent only the creation of a 'legal priorities' system and that favouring one creditor over another did not run afoul of the *pari passu* clause.[13] The Second Circuit interpreted the first sentence[14] of the clause to prohibit Argentina, in its capacity as the bond issuer, from subordinating the FAA Bonds by issuing superior debt. By the second sentence[15] Argentina, in its capacity as bond payor, was prohibited from paying other bonds without also paying the FAA Bonds. Thus, the Second Circuit adopted an interpretation of the *pari passu* clause that protected the FAA bondholders from the issuance of superior debt and from having Argentina prioritise payment of certain bond debt over the FAA Bonds.

The Second Circuit relied on the district court's findings that Argentina violated the *pari passu* clause by (i) failing to make any payments under the FAA Bonds since 2001 while making payments under the Exchange Bonds, and (ii) enacting the Lock Law which precluded making payments under the FAA Bonds and barred Argentine courts from recognising

Notes

5 The FAA is governed by New York law and provided courts within New York with jurisdiction over the matter.
6 *Id.* at 255.
7 *NML Capital, Ltd. v Republic of Arg.*, No. 08 Civ. 6978, 2012 U.S. Dist. LEXIS 167272, at * 7-8 (S.D.N.Y. Nov. 21, 2012).
8 *Id.*
9 *NML Capital*, 699 F.3d at 255.
10 *Id.*
11 *Id.* at 258.
12 *Id.* at 251.
13 *Id.*
14 'The Securities will constitute ... direct, unconditional, unsecured and unsubordinated obligations ... and shall at all times rank *pari passu* without any preference among themselves.'
15 'The payment obligations ... shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness.'

any judgments related to the FAA Bonds. The Second Circuit emphasised that it was the combination of Argentina's actions as payor and legislator taken during the restructuring that led to its holding.

B. Enforcement

The Second Circuit affirmed the district court's grant of specific performance because a monetary remedy would be insufficient to provide the plaintiffs with relief on account of Argentina's and its courts' refusal to recognise foreign judgments pursuant to the Lock Law.

Thus, the Second Circuit recognised that it could rule in favour of the plaintiffs and award damages in virtually any amount but such a ruling would be worthless because the plaintiffs would have no ability to enforce the judgment in Argentina. Accordingly, the Second Circuit identified that if Argentina itself could not be made to honour the court's ruling, perhaps its intermediary banks and third parties could be made to honour the ruling when money is delivered to them to pay the holders of the Exchange Bonds.

The Second Circuit, however, had concerns over the injunction as it related to the Ratable Payment provision and the ability to enjoin third parties. The Second Circuit noted that the Ratable Payment provision could be interpreted in several ways that could result in different payment schemes. Moreover, under the Uniform Commercial Code, banks that are mere intermediaries and that have no obligations to any party with whom they do not deal directly are immune for injunctive relief. As such, the Second Circuit remanded the application of the Ratable Payment provision and the scope of the injunction as it relates to third parties back to the district court for clarification.

IV. Subsequent proceedings

On remand, the district court clarified the meaning of the Ratable Payment provision and the scope of the injunction. With respect to the Ratable Payment provision, the district court held that whenever Argentina pays an obligation owed under the Exchange Bonds, Argentina has to pay the same percentage paid of the obligation owed under the Exchange Bonds to the holders of the FAA Bonds of the total amount outstanding under the FAA Bonds. By way of example, the district court noted that an interest payment of USD 3.14 billion would be due under the Exchange Bonds. Under the Ratable Payment provision, if Argentina would pay the full USD 3.14 billion, then Argentina would have to pay the holders of the FAA Bonds 100% of the amount currently due under the FAA Bonds, which was approximately USD 1.33 billion. The district court justified this remedy because it 'bear[s] some reasonable relation' to the intent of the *pari passu* clause, namely a proportional payment of the debt owed to the FAA bondholders upon payment under the Exchange Bonds.[16] Finally, with respect to the third party injunction, the district court held that the injunction applied to Argentina, the indenture trustees for the Exchange Bonds, the registered owners of the Exchange Bonds, and the clearing system, so long as no parties involved constituted an intermediary bank.[17]

Argentina again appealed the district court's order to the United States Court of Appeals for the Second Circuit, which again denied Argentina's appeal as well as an appeal to rehear the Second Circuit's prior decision *en banc*. However, during oral arguments Argentina indicated that it was willing to 'abide by a different formula'[18] to repay both the FAA Bonds and the Exchange Bonds. The Second Circuit granted Argentina the opportunity to submit additional briefing setting forth a specific framework to repay its debt, including (a) the time frame required to make current the FAA Bond obligations; (b) the rate at which Argentina proposes to repay the FAA Bonds; and (c) assurances that the necessary government actions necessary to implement its proposal will be taken.[19] As of the date of this publication, the issue of an alternative payment mechanism is being briefed and no further decision has been rendered by the Second Circuit.

V. Conclusion

The *NML* decision resulted in an overwhelming legal victory for the FAA bondholders. More importantly, the Second Circuit's interpretation of the *pari passu* clause could have a significant impact on the structure of sovereign debt issuances in the future. Nations issuing debt will likely be forced to take a closer review of the terms of its debt issuances in order to avoid the situation that Argentina faced. The case is also important because the Second Circuit provided the bondholders with comprehensive injunctive relief, rather than relying on the default remedies provided under the FAA. In reaching its decision, the Second Circuit appeared to be concerned over the lack of protections that creditors of a sovereign nation have on account of a nation's

Notes

16 *NML Capita*, 2012 U.S. Dist. LEXIS 167272, at *13.
17 *Id.* at *18.
18 *NML Capital, Ltd. v Republic of Arg.*, No. 12-105(L) (2d Cir. Mar. 1, 2013) [Docket No. 903].
19 *Id.*

general inability to seek bankruptcy or other insolvency relief.[20] As such, the *NML* decision highlights the need for potential bond purchasers to look out for their own interests in negotiating with a nation over the terms of a debt issuance.

On the other hand, the *NML* decision has raised concerns about a nation's ability to restructure its debt. Indeed, if courts elsewhere adopt the Second Circuit's interpretation of *pari passu* clauses, nations may find it harder to negotiate a potential restructuring of its debt in the future. Moreover, the presence of collective action clauses may not provide as much relief to nations as the Second Circuit envisioned. If bondholders believe that a court will adopt the Second Circuit's interpretation of a *pari passu* clause, then it may deter enough bondholders from acquiescing to a proposed modification, thus preventing the bond issuer from reaching the threshold necessary to invoke the collective action clause.

However, even if courts adopt the Second Circuit's interpretation, it is unclear if merely paying one creditor over another would violate a *pari passu* clause. At the heart of the *NML* case is the notion that a nation cannot use its political capabilities (*i.e.*, its legislative powers) to buttress its actions and decisions as a market actor. The Second Circuit expressed concerned over Argentina's use of the political process – introducing a moratorium on bond payments, passing the Lock Law and then suspending the law when it benefited Argentina's position – in order to procure the restructuring result it desired. Thus, it remains to be decided further if a court would reach a similar conclusion where a nation attempts a restructuring without the political pitfalls that Argentina encountered.

Notes

20 *NML Capital*, 699 F.3d at 256 (stating that '[t]he public interest of enforcing contracts and upholding the rule of law will be served by the issuance of th[ese] [Injunctions], particularly here, where creditors of the Republic have no recourse to bankruptcy regimes to protect their interests and must rely upon courts to enforce contractual promises. No less than any other entity entering into a commercial transaction, there is a strong public interest in holding the Republic to its contractual obligations.').

COMI Determinations: The Point in Time is Certain, but Factors are Limitless

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In *In re Fairfield Sentry Ltd.*,[1] the United States Court of Appeals for the Second Circuit ('Second Circuit') clarified the relevant time for determination of chapter 15's concept of centre of main interest ('COMI'), and resolved a split among decisions. The Second Circuit ruled that for purposes of recognition under chapter 15, the time of filing of the chapter 15 petition is the relevant period for COMI consideration. The time between the commencement of foreign insolvency proceedings and the chapter 15 filing can be considered if COMI may have been subject to manipulation. In addition, the Second Circuit held that the relevant principle for determining COMI is that it lies where the debtor conducts its regular business, so that COMI is ascertainable by third parties. Rather than limiting the scope of COMI determination to any exclusive list of factors, the Second Circuit held that any relevant activities of the debtor could be considered. The decision facilitates COMI determinations by limiting them to a certain point in time, but it also seems to add more uncertainty by inviting unrestricted considerations of circumstances defining COMI.

Background

In 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act ('BAPCPA') added chapter 15 to the Bankruptcy Code, and repealed Bankruptcy Code section 304, which was, until then, the gateway for U.S. bankruptcy courts to assist in foreign insolvency proceedings. Chapter 15, which incorporates the Model Law on Cross-Border Insolvency ('Model Law'),[2] provides a simple process of recognising a foreign proceeding as either main or nonmain,[3] depending on whether the foreign proceeding is pending in the location of the debtor's COMI or establishment.[4] The distinction is material, because certain relief, including the imposition of the automatic stay of all proceedings against the debtor in the US, is granted automatically upon recognition of a foreign main proceeding.

There is no definition of COMI in either chapter 15 or the Model Law, other than a presumption that absent evidence to the contrary, COMI is presumed to be in the location of the debtor's registered office.[5] While there is no statutory guidance on what type of evidence is required to overcome this presumption, relevant factors could include the location of the debtor's headquarters; the location from which the managing decisions are made (i.e., the holding company's headquarters); the location of the debtor's main assets, the location of the majority of the debtor's creditors or of a majority of the creditors who would be affected by the case; and/or the jurisdiction whose law would apply to most disputes.[6]

The uncertainty related to the determination of a debtor's COMI deepened with conflicting decisions regarding the relevant time for the determination of COMI. Bankruptcy Code section 1517(b) provides

Notes

1 *Morning Mist Holdings Ltd. v Krys (In re Fairfield Sentry Ltd.)*, Case No. 11-4376, 2013 U.S. App. LEXIS 7608 (3d Cir. V.I. Apr. 16, 2013).

2 See 11 U.S.C. § 1501. The Model Law was promulgated by the United Nations Commission on International Trade Law at its Thirtieth Session on May 12-30, 1997, UN Sales No. E.99V.3, 1999.

3 A foreign main proceeding is a foreign proceeding pending in the country where the debtor's COMI is. See 11 U.S.C. §§ 1502(4), 1517(b)(1). A foreign nonmain proceeding is a foreign proceeding, other than a foreign main proceeding, pending in the country where the debtor has an establishment, which is any place of operations where the debtor carries out a nontransitory economic activity. See 11 U.S.C. §§ 1502(2), 1502(5), 1517(b)(2).

4 A case under chapter 15 is commenced by a foreign representative filing a petition for recognition of a foreign proceeding under section 1515 of the Bankruptcy Code. See 11 U.S.C. § 1504. The petition for recognition must be accompanied by evidentiary documents which are presumed to be authentic in the absence of evidence to the contrary. See 11 U.S.C. §§ 1515(b), 1516(b). An order recognising a foreign proceeding is entered if: (i) such proceeding is either foreign main or foreign nonmain, as defined in section 1502 of the Bankruptcy Code; (ii) the foreign representative applying for recognition is a person or body; and (iii) the petition meets the required form. See 11 U.S.C. § 1517. The burden to prove each element is on the foreign representative. See 8 *Collier on Bankruptcy* ¶ 1516[3] (16th ed. 2012).

5 See 11 U.S.C. § 1516; Model Law on Cross-Border Insolvency, § 16(3).

6 See *In re SPhinX, Ltd.*, 351 B.R. 103, 117 (Bankr. S.D.N.Y. 2006); *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (In re Bear Stearns)*, 374 B.R. 122, 128 (Bankr. S.D.N.Y. 2007).

that '[a] foreign proceeding shall be recognized ... as a foreign main proceeding if *it is pending* in the country where the debtor *has* the centre of its main interest.' Certain courts ruled that for COMI purposes, the time of the chapter 15 petition filing was relevant rather than the commencement date of the foreign proceeding. These decisions were based on the present tense of the statute and precedence arising from the EU Insolvency Regulation, which focused on the date when a petition was filed, rather than the time when the debts were incurred. In addition, using operational history would allow for more open-ended determinations of COMI to the detriment of predictability.[7] This approach was rejected by the court in *In re Millennium Global*.[8] The decision noted that courts generally explained COMI as the 'principal place of business' in U.S. law,[9] which ceased to exist after liquidation was ordered and the business stopped operating, or merely became the place of business of the reorganised entity, as opposed to the debtor.[10] The *Millennium* court also noted that practice based on former Bankruptcy Code section 304 looked at the time of commencement of the foreign proceeding to determine the location of COMI. Finally, looking at the Model Law and the EU Insolvency Regulation as sources of interpretation, the *Millennium* court found that the original drafters of the EU Insolvency Regulation (to which the Model Law pointed to for an explanation of COMI) could have only had one relevant time in mind, and that is the commencement of the original foreign proceeding. Indeed, from a procedural standpoint, the EU Insolvency Regulation is different from chapter 15 in that foreign proceedings are automatically recognised in other EU members, and no additional recognition occurs – and with that, no second relevant point in time.

Fairfield Sentry: the story behind

Fairfield Sentry Limited ('Sentry') was established in 1990 as an 'International Business Company' under British Virgin Islands ('BVI') laws, and was one of the largest feeder funds that invested with Barnard L. Madoff Investment Securities LLC. Sentry's registered office, registered agent, registered secretary, and corporate documents were located in the BVI. The fund's investment manager, Fairfield Greenwich Group, was based in New York, and Sentry's three directors resided in New York, Oslo and Geneva, respectively.

After the collapse of Madoff's fund, Sentry's directors started winding down the company. In July 2009, Sentry entered into liquidation proceedings in the BVI, and in June 2010, the BVI liquidator petition in the United States Bankruptcy Court for the Southern District of New York (the 'Bankruptcy Court') for recognition of the BVI proceedings under chapter 15 of the Bankruptcy Code. After examining Sentry's activity between the beginning of its winding down and its chapter 15 petition, the Bankruptcy Court found Sentry's COMI to be in the BVI and recognised the BVI liquidation as foreign main proceeding. Such recognition automatically stayed a derivative action brought in May 2009 by Morning Mist, Sentry's shareholder, in New York state court against Sentry's directors, management, and service providers.[11] Morning Mist appealed, but the district court affirmed the Bankruptcy Court's recognition order and found that the time of its chapter 15 filing was proper for COMI considerations as opposed to Sentry's operational history.[12] Morning Mist had also argued that recognition of the BVI liquidation would be manifestly contrary to U.S. policy (in which case recognition is barred pursuant to the public policy exception in Bankruptcy Code section 1506), because court records were sealed. The district court rejected this argument, claiming that the right of public access to court records is not absolute.[13] Morning Mist appealed again.

The Second Circuit decision

a) Relevant time period for COMI determination

To determine the appropriate time for COMI consideration, the Second Circuit considered (i) the text of the statute; (ii) guidance from other federal courts, and (iii) international resources, and concluded that the time of

Notes

7 See *In re Fairfield Sentry Ltd.*, 2011 U.S. Dist. LEXIS 105770 (S.D.N.Y. Sept. 15, 2011); *In re British Am. Isle of Venice Ltd.*, 441 B.R. 713, 720 (Bankr. S.D. Fla. 2010); *In re British Am. Ins. Co., Ltd.*, 425 B.R. 884 (Bankr. S.D. Fla. 2010); *In re Betcorp.*, 400 B.R. 266, 290-91 (Bankr. D. Nev. 2009); *In re Ran*, 390 B.R. 257, 300 (Bankr. S.D. Te. 2008), *aff'd*, 406 B.R. 277 (S.D. Tex. 2009), *aff'd*, 607 F.3d 1017 (5th Cir. 2010).

8 *In re Millennium Global Emerging Credit Master Fund, Ltd.*, 458 B.R. 63 (Bankr. S.D.N.Y. 2011), *aff'd*, 2012 U.S. Dist. LEXIS 88782 (S.D.N.Y. June 25, 2012).

9 *In re Tri-Continental Exchange Ltd.*, 349 B.R. 627, 634 (Bankr. E.D. Cal. 2006); see also *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 48 (Bankr. S.D.N.Y. 2008); *In re Betcorp*, 400 B.R. at 287-88.

10 *In re Millennium Global*, 458 B.R. at 72-73.

11 The Bankruptcy Court noted that even if the BVI had been recognised as foreign nonmain proceeding (i.e., if Sentry only had an establishment in the BVI rather than its centre of main interest), a stay of the derivative action would have been appropriate under Bankruptcy Code section 1521, which gives the court discretionary power to grant appropriate relief, including the automatic stay, upon the request of a foreign representative. *In re Fairfield Sentry Ltd.*, 440 B.R. 60. 67 (Bankr. S.D.N.Y. 2010).

12 *In re Fairfield Sentry Ltd.*, No. 10 Civ. 7311 (GBD), 2011 U.S. Dist. LEXIS 105770, *20-22 (S.D.N.Y. Sept. 16, 2011).

13 *Id.* at *25-26. The Second Circuit also refused to adopt the public policy exception asserted by Morning Mist.

the chapter 15 filing was appropriate for COMI considerations, with the exception that the period beginning at the commencement of the foreign proceedings could be taken into consideration the ensure the absence of COMI manipulations.

Comparing it to the language regarding disinterestedness of professionals in Bankruptcy Code section 327(a), the Second Circuit was persuaded that the present tense of the language in Bankruptcy Code section 1517 that '[a] foreign proceeding shall be recognized ... as a foreign main proceeding if *it is pending* in the country where the debtor *has* the center of its main interest,' indicated that COMI should be examined at the time of the chapter 15 petition filing. A similar explanation has been adopted by the United States Court of Appeals for the Fifth Circuit (the only other circuit court that had tackled the issue before), which opined that '[i]f Congress had, in fact, intended bankruptcy courts to view the COMI determination through a look-back period or on a specific past date, if could have easily said so,' like it did in Bankruptcy Code 522(b)(3)(A),[14] for example.[15] The Fifth Circuit also noted that such interpretation allowed for the harmonisation of COMI, because looking back at a debtor's operational history could allow for more locations to be considered as COMI. The Fifth Circuit did leave room for exceptions in cases of COMI manipulations.

In looking at decisions within the circuit, the Second Circuit noted that the majority followed the rule of determining COMI at the time of the chapter 15 filing. The Second Circuit adopted the majority view and rejected the *Millennium* court arguments, finding that Congress intentionally adopted the COMI concept instead of using the 'principal place of business' and abandoned the language of former Bankruptcy Court section 304, which looked at the commencement of the foreign proceeding to determine the principal place of business.

Finally, the Second Circuit found international resources to be of limited use in determining the best time for COMI considerations under chapter 15. The Second Circuit agreed with the *Millennium* court that the EU Insolvency Regulation presents a different procedural platform due to a single relevant time, however, the Second Circuit refused to base its interpretation on the EU Insolvency Regulation. Instead, the Second Circuit held that different procedural standpoints suggest the 'EU Regulation may be a poor analog for interpreting Chapter 15.'[16] With respect to European case law, the Second Circuit found that it seemed to focus on whether COMI was regular and ascertainable, and not subject to manipulation. Similarly, the Second Circuit allowed for a court to consider the period between the commencement of the foreign proceeding and the chapter 15 filing to ensure that COMI had not been manipulated in bad faith.

b) COMI factors

In its brief discussion of COMI factors, the Second Circuit pointed to the list of relevant factors adopted in *In re SPhinX* as a 'helpful guide, but consideration of these specific factors is neither required nor dispositive.'[17] The Second Circuit clarified that any relevant activities of the debtor, including liquidation activities and administrative functions, may be taken into consideration for COMI purposes, and that the COMI concept 'invites development by courts, depending on facts presented, without prescription or limitation.'[18] Even though the Second Circuit emphasised the importance of factors indicating regularity and ascertainability, as underscored in the EU Insolvency Regulation, these very concepts seem to be undermined by the Second Circuit's open-ended approach.

While the *Fairfield Sentry* decision resolves the issue of timing, this holding may have opened the doors for even broader interpretations (and litigation) of COMI, and, consequently, less certainty.

Notes

14 Bankruptcy Code section 522(b)(3)(A) provides: 'Property listed in this paragraph is ... any property that is exempt under Federal law ... or State or local law that is applicable on the date of the filing of the petition to the place in which the debtor's domicile has been located for the *730 days immediately preceding the date of the filing of the petition* or if the debtor's domicile has not been located in a single State for such 730-day period, the place in which the debtor's domicile was located *for 180 days immediately preceding the 730-day period or for a longer portion of such 180-day period* than in any other place.' (emphasis added)

15 *In re Ran*, 607 F.3d 1017, 1025 (5th Cir. 2010).

16 *In re Fairfield Sentry Ltd.*, 2013 U.S. App. LEXIS 7608 at *22 n. 7.

17 *In re Fairfield Sentry Ltd.*, 2013 U.S. App. LEXIS 7608 at *25.

18 *Id.* at *26-27.

Lazari GP Ltd v Jervis, the Rights of Landlords in Administration

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Introduction

On 11 May 2012 judgment was handed down in *Lazari GP Ltd v Jervis*.[1] Mr Justice Briggs ('Briggs J'), sitting in the Chancery Division of the High Court granted the landlords of a property, of which the tenant was in administration, permission to forfeit a lease provided that it did not affect or impede the administration of the tenant company. Paragraph 43, Schedule B1 of the Insolvency Act 1986 ('Paragraph 43') protects a company in administration by way of a 'moratorium' that prevents creditors or other third parties from taking action against the company or its assets including exercising forfeiture by peaceable re-entry without the leave of the court.[2]

Circumstances in which the court will grant leave

The courts have traditionally been reluctant to allow the moratorium to be pierced unless the effect on the administration is minimal. There have been several previous cases in this area, most notably *Re Atlantic Computer Systems Plc*,[3] and *Innovative Logistics Limited v Sunberry Properties Limited*.[4]

In *Re Atlantic Computer Systems* the court held that there were several factors to be considered by the courts in determining whether or not to give leave for proceedings to be brought even though the company was in administration. The court emphasised that the administrators should respond quickly and reasonably to applications for leave to bring proceedings and where possible these issues should be settled out of court. The court stated that if the granting of leave does not impede the process of administration then it should normally be given, and in other cases the courts must carry out a balancing exercise to determine whether it would be inequitable for leave to be denied. In the case of a lease, if significant loss would be caused to a lessor if it could not bring proceedings due to the moratorium, then this will normally be sufficient grounds for the court or the administrator to grant leave.

The *Sunberry* case set out that the moratorium also applied to restrict the landlord's remedies where an administrator of a tenant company had breached a lease by licensing occupation of premises to another company, without seeking or obtaining the landlords' consent. The landlords were unsuccessful in this case because the Court of Appeal decided that based on the balancing exercise established in *Re Atlantic Computer Systems*, the process of administration would be impeded by the landlords' request.

These cases provide guidance on the circumstances under which a creditor or third party will be given leave to bring proceedings against a company in administration despite the statutory moratorium. The decisions make it clear that if a landlord wishes to commence proceedings during the statutory moratorium, the landlord must show that the exercise of its rights will not impede the purpose and course of the administration.

Lazari GP Ltd – the facts

Game Retail (UK) Limited ('Game Retail') gave notice to appoint administrators to its landlords Lazari GP Limited and Lazari Real Estates Limited ('Lazari'), on 21 March 2012. Game Retail was a tenant in occupation of prime retail property on Oxford Street in London. Rent for the property was due on 25 March 2012 with approximately one year remaining on a ten year lease. Game Retail failed to pay rent by the deadline and on 26 March 2012 Game Retail went into administration. The administrators notified the landlords that they intended to make use of the property without adopting a new lease meaning they were bound by the terms of the existing lease which contained covenants not to part with, or share occupation of the premises and also contained a qualified covenant against assignment. The lease also stated that forfeiture procedures could

Notes

1 [2012] EWHC 1466 (Ch).
2 Paragraph 43(4), Schedule B1 of the Insolvency Act 1986 (as amended).
3 [1992] Ch 505.
4 [2008] EWHC 2450 (Ch).

be triggered by Lazari if there were arrears in rent, a breach of the obligation not to part with or share occupation or possession, and/or insolvency.

On 31 March 2012 a pre-packaged sale of the business was agreed between Game Retail and Baker Acquisitions Limited ('Baker'). As part of the sale process Baker went into immediate occupation of several of the Game Group's trading premises, including the property on Oxford Street, under a licence from the Game Group. In the purchase agreement, Baker acknowledged that the licence to occupy could amount to a breach of the lease between Game Retail and Lazari. Baker accepted the risk that its occupation was a breach of the lease between Lazari and game Retail and went into occupation of the Oxford Street premises on 31 March 2012. Two days later Lazari served a section 146 notice[5] on Game Retail stating that it was in breach of the covenants of the lease because it was insolvent and Baker was in shared occupation, it also made reference to the arrears in rent. However, at this point Game Retail was in administration and therefore protected by the moratorium. Lazari sought consent from the administrators for leave to forfeit the lease. The administrators denied the request for forfeiture on 12 April 2012 and gave no reason for their denial.

On 16 April 2012 Baker applied to Lazari for its consent to the assignment of the lease from Game Retail to Baker. However, Baker did not provide any background information about itself or any compelling reason as to why the assignment should be allowed. To compound the issue Baker was a new company with a limited trading history, which was probably incorporated as a special purpose vehicle for the purchase of the business of Game Retail. Lazari refused to consent to the assignment of the lease due to this lack of information about Baker. Baker made no attempt thereafter to appeal the decision of Lazari, and the matter was not followed up.

Lazari had simultaneously been engaging in lease negotiations with a well established retail chain. The negotiations were progressing well and the new lease was to be at a higher rent than the current rate, with strong covenants. Due to the positive development in the negotiations and the unsubstantiated rejection of Lazari's request to forfeit the lease by the administrators, Lazari applied to court for the forfeiture of the lease, despite the moratorium, based on the principles established in *Re Atlantic Computer Systems*. Lazari's argument was that there would be no adverse affect on the process of the administration and that being barred from forfeiture would cause Lazari to incur significant financial damages.

Issues before the court

(1) Would the administration of Game Retail be adversely affected by a forfeiture of the lease?

(2) How did Baker's involvement change the nature of the situation?

(3) What did Lazari stand to lose if a forfeiture of the lease was not granted?

(4) How should forfeiture be allowed?

Briggs J's decision

Would the administration of Game Retail be adversely affected by a forfeiture of the lease?

Briggs J held that the actions of Lazari were correct and justified given the nature of the circumstances, and that this was the correct use of the principle in *Re Atlantic Computer Systems*. Briggs J held that in this case the administration of Game Retail would not be significantly affected by the forfeiture of the lease. Briggs J pointed out that the purpose of the administration had been substantially achieved by the pre-pack sale of the business, and giving Lazari its right to forfeit would in no way interfere with that process. If the sale had not been completed then the impact on the administration could have been substantial. It was noted by Briggs J that the administrators had failed to show any conclusive and substantial evidence that the aim of the administration would be compromised by the forfeiture of the lease.

How did Baker's involvement change the nature of the situation?

Briggs J considered the fact that Baker was given occupation under a licence with 'full risk of the consequences of occupation' which meant that all responsibility had been lifted from the administrators, and the forfeiture of the lease would have 'no adverse consequences for the administration.' Baker was fully aware of the risk that it had taken, and was in effect the only party that stood to lose from the forfeiture. Briggs J pointed out that Baker's application for consent to assignment was 'half-hearted,' and he stressed the point that the application had not been pursued by Baker.

Notes

5 Section 146 of The Law of Property Act 1925.

What did Lazari stand to lose if a forfeiture of the lease was not granted?

Briggs J also addressed the point that Lazari had a genuine prospect of suffering loss, if not allowed to forfeit the lease. Lazari were able to provide clear evidence that delaying or barring forfeiture would cause it considerable financial damage. Not only did it have rent arrears owing to it, but it stood to lose out on advanced negotiations for the grant of a new lease with a satisfactory retail chain, at a higher rent, with strong covenants. When Briggs J weighed this potential loss against the affects on the administration it was clear that granting the forfeiture was the only equitable choice.

How should forfeiture be allowed?

Briggs J stated that the court had the jurisdiction to decide how a landlord would enforce the forfeiture and regain possession of the property. Briggs J stated that if Baker was unhappy with the forfeiture it could seek independent proceedings against Lazari, which they had not done. Therefore Briggs J granted the requested relief for forfeiture by peaceful re-entry.

Commentary

Landlords will welcome the decision of Briggs J in *Lazari GP Ltd v Jervis* as it helps to clarify when the court is likely to grant leave to landlords to forfeit the lease of a tenant that is in administration.

The principles set out in *Re Atlantic Computers* were fully applied in *Lazari*. The decision favoured the landlord, for whom delay in forfeiting the lease would have had a severe financial impact. Conversely forfeiture would not have impacted on the main purpose of the administration. To prevent the landlord from forfeiting the lease in such circumstances would have been inequitable.

This decision also reminds administrators that although a company in administration benefits from the protection of a moratorium, if a landlord seeks their permission to forfeit a lease they must consider the request in a reasonable manner and cannot simply withhold consent where there is no clear and significant detriment to the administration by doing so.

Sales of Foreign Debtors' Assets: Approval is not to be 'Rubber Stamped' by US Courts in Chapter 15

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In the chapter 15 case of Elpida Memory, the United States Bankruptcy Court for the District of Delaware (the 'Bankruptcy Court') considered the standard of review applicable to a sale of a foreign debtor's assets previously approved in its main insolvency proceeding: should courts approve such sales based on comity principles or conduct a plenary review under Bankruptcy Code section 363? Based on its interpretation of the statute, the Bankruptcy Court ruled that sales of assets located in the United States must be reviewed pursuant to the standards of sound business purpose, fair price, adequate notice and good faith required to approve a section 363 sale.[1]

Background

Elpida Memory, Inc., a Japanese corporation that develops, designs, manufactures and sells dynamic random-access memory ('DRAM') products, commenced reorganisation proceedings under the Japan Corporate Reorganization Act in the Tokyo District Court on 27 February 2012. The Tokyo District Court appointed two trustees and an examiner.

On 19 March 2012, one of the trustees filed a chapter 15 petition pursuant to Bankruptcy Code sections 1504 and 1515.[2] On 24 April 2012, the Bankruptcy Court recognised the Japanese reorganisation proceedings as foreign main proceeding and the Japanese trustees as foreign representatives. Notably, due to concerns raised by US creditors, the Bankruptcy Court modified the recognition order and explicitly prohibited the foreign representatives from selling 'Elpida's U.S. assets or interests without first ... obtaining approval of [the Bankruptcy Court].'[3]

In September 2012, the foreign representatives filed four motions (the '363 Motions') under Bankruptcy Code section 363 seeking Bankruptcy Court authorisation to enter into four related transactions, which were previously approved in the Japanese reorganisation proceedings: (i) the pledge of certain US registered patents to Apple Inc. (the 'Apple Motion'), (ii) a security agreement related to post-petition financing (the 'DIP Motion'), (iii) the sale of certain patents to Rambus Inc. (the 'Rambus Motion'), and (iv) the patent license agreement and technology transfer and license agreement with Micron Technology Inc. ('Micron' and the 'Micron Motion').[4] The trustees also filed motions under Bankruptcy Code section 1507[5] to redact confidential information contained in the 363 Motions.

The Steering Committee of the Ad Hoc Group of Bondholders (the 'Bondholders') objected to all four 363 Motions, including the motion to seal certain confidential information related to the Micron Motion. The Bondholders later withdrew their objection to the Apple Motion and the DIP Motion, and the Bankruptcy Court entered orders approving these motions on 31 October 2012.

The two remaining motions at issue contemplated the sale of certain patents, including some registered in the US and subject to the territorial jurisdiction of the US. The Rambus Motion sought approval of the Patent Purchase Agreement ('PPA'), under which Elpida sold its patents to Rambus, and Rambus granted Elpida a royalty-free, perpetual license to Elpida. The Micron Motion sought approval of a Patent License Agreement

Notes

1 See *In re Elpida Memory, Inc.*, Case No. 12-10947 (CSS), 2012 Bankr. LEXIS 5367 (Nov. 16, 2012) ('Elpida').
2 See *In re Elpida Memory Inc.*, Case No. 12-10947 (CSS) (Bankr. D. Del. Mar 19, 2012) [Docket No. 1].
3 See *In re Elpida Memory Inc.*, Interim Order Modifying Order Recognizing Foreign Representatives and Foreign Main Proceeding, Case No. 12-10947 (CSS) (Bankr. D. Del. Sep. 18, 2012) [Docket No. 138].
4 In the Micron Motion, the trustee claimed entering such agreement was in the ordinary course of Elpida's business and did not require approval under Bankruptcy Code section 363, but concluded it was in Elpida's best interest to seek Bankruptcy Court approval out of abundance of caution. *In re Elpida Memory Inc.*, Micron Motion at ¶ 14, 15, Case No. 12-10947 (CSS) (Bankr. D. Del. Sep. 28, 2012) [Docket No. 165].
5 Bankruptcy Code section 1507 allows court to grant any additional assistance available under the Bankruptcy Code or under other laws of the United States, provided that such assistance is consistent with principles of comity and satisfies the fairness considerations set out in the statute. See 11 U.S.C. § 1507.

('PLA'), under which Elpida granted Micron a non-exclusive, royalty-free, non-sublicensable, perpetual and irrevocable license to the patents being sold to Rambus. The Japanese court approved the PPA and PLA on 10 August 2012.

Standard of interpretation: comity or sound exercise of business judgment?

Bankruptcy Code section 1520 sets forth the effects of recognition of a foreign main proceeding. Upon recognition, Bankruptcy Code section 363 applies 'to a transfer of an interest of the debtor in the property *that is within the territorial jurisdiction of the United States*.' Section 363(b)(1) provides that the 'trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.' Under section 1520(a)(3), 'the foreign representative may operate the debtor's business and may exercise the rights and powers of a trustee under and to the extent provided by section[] 363.'

The sale of assets located in the US could clearly be effectuated pursuant to Bankruptcy Code section 363. The parties, however, disagreed as to which standard should be applied. The trustees claimed the Bankruptcy Court should defer to the Japanese court's approval based on comity principles, or, at most, review the transactions only under Bankruptcy Code section 1506 to ensure that the Japanese insolvency regime as a whole is not manifestly contrary to US public policy.[6] On the opposite end, the Bondholders insisted the Bankruptcy Court has an independent duty to review the transactions under the the sound exercise of business judgment standard applicable to a sale, use, or lease of property out of the ordinary course of business under section 363(b). This standard is satisfied when the following four requirements exist: (1) there is sound business purpose for the sale; (2) the price is fair; (3) adequate and reasonable notice is given by the debtor; and (4) the purchaser has acted in good faith.[7]

The Bankruptcy Court first reviewed the plain meaning of the Bankruptcy Code and concluded that the statute clearly provides Bankruptcy Code section 363 and its standard of review apply to the transfer of assets located in the US by a foreign debtor in a foreign main proceeding outside the ordinary course of business. Finding that 'applying the plain meaning of the statute is the default entrance – not the mandatory exit,'[8] and that in chapter 15 cases plain meaning should be subordinate to legislative history or general principles of comity,[9] the Bankruptcy Court analyzed the Model Law[10] for further guidance on the interpretation of section 1520. The corresponding provision of the Model Law is two-fold: it seeks to protect the debtor by stopping all action against the debtor's assets in all jurisdictions, and it also protects creditors by stopping the debtor from transferring its assets without court order. With respect to the latter, the Model Law 'follows an *in rem* division of labor between sovereignties,'[11] and imposes the laws of the jurisdiction *in which such assets are located*, and not the laws of the plenary proceeding.

As for comity principles, the Bankruptcy Court noted that while promoting comity is a general objective of chapter 15, 'it is not the end all be all of the statute … [t]o require [US courts] to defer in all instances to foreign court decision would gut section 1520.'[12] The Bankruptcy Court emphasised that only two provisions of chapter 15 expressly mention comity: (i) section 1507 allows courts to grant 'additional assistance' available under the Bankruptcy Code or other laws of the US if such assistance is consistent with the principles of *comity* and satisfies fairness considerations; and (ii) section 1509(b)(3) requires a US court to grant *comity* or cooperation to a foreign representative upon recognition under section 1517. The Bankruptcy Court also noted that the rules of interpretation of chapter 15 in section 1508 do not include comity.[13] In *Elpida*, neither section 1507 nor section 1509(b)(3) were applicable, as the trustees were not looking for 'additional assistance,' and 1509(b)(3) requires courts to grant comity to a *foreign representative*, not a foreign court's orders.

Based on both the plain meaning of the statute and legislative history, the Bankruptcy Court ruled that the proposed sale of assets must be reviewed *de novo* as it related to property in the US, and must be reviewed under the sound business judgment standard applicable to section 363 sales.

In January 2013, the Bankruptcy Court issued a decision confirming that the transactions proposed in

Notes

6 Bankruptcy Code section 1506 provides for a public policy exception, which allows courts to refuse to take an action under chapter 15 if such action would be manifestly contrary to the public policy of the US.
7 *Elpida* at *18, citing *In re Delaware & Hudson Railway Co.*, 124 B.R. 169, 176 (D. Del. 1991).
8 *Elpida* at *16 (internal citations omitted).
9 *Id.* at *18–19.
10 Model Law on Cross-Border Insolvency, promulgated by the United Nations Commission on International Trade Law at its Thirtieth Session on May 12-30, 1997, UN Sales No. E.99V.3, 1999.
11 *Elpida* at *23.
12 *Id.* at *27.
13 Section 1508 provides that in interpreting chapter 15, courts must consider (i) its international origin; and (ii) the need to promote an application of chapter 15 that is consistent with the application of similar statutes adopted by foreign jurisdictions.

the Rambus Motion and the Micron Motion satisfy the requirements of Bankruptcy Code section 363(b). The Bondholders promptly filed a motion for reconsideration of the Bankruptcy Court's order granting the two motions, which was denied. The Bondholders then filed an appeal to the order approving the Rambus Motion and the Micron Motion, and the order denying their motion for reconsideration. Finally, the appeal was dismissed with prejudice on 17 June 2013, as the parties had reached a settlement agreement.[14] In the meanwhile, the Japanese court approved Elpida's plan of reorganisation. On 22 May 2013, the trustees filed a motion seeking Bankruptcy Court's recognition and enforcement of the Japanese plan.

In re Fairfield Sentry: a different direction – or not?

Shortly after the *Elpida* decision, the United States Bankruptcy Court for the Southern District of New York tackled a substantially similar issue: namely, whether to review a decision of a British Virgin Islands ('BVI') court approving a sale of the debtor's assets under the section 363 sound business judgment standard. In *In re Fairfield Sentry Ltd.*, 484 B.R. 615 (Bankr. S.D.N.Y. 2013), the debtor ('Fairfield') was one of the largest feeder funds that invested with Barnard L. Madoff Investment Securities LLC ('BLMIS'). Fairfield filed certain claims in the liquidation of BLMIS under the Securities Investor Protection Act ('SIPA'), which were allowed in the amount of USD 230 million. Fairfield's foreign representative held an auction for the SIPA claims, and ultimately sold them for about a third of the allowed amount. Just days after the sale was finalised, the SIPA trustee announced a settlement that significantly increased the trading price of SIPA claims.

Realising its loss, the foreign representative did not immediately submit the SIPA claims sale to the BVI court for approval. After the purchaser sought court order directing the foreign representative to do so, the BVI court held an evidentiary hearing and found that the sale was valid and approval was warranted. However, the BVI court deferred to the US court for issues of US bankruptcy law, stating that if the US court 'decides, for whatever reason, to withhold approval of the Trade Confirmation, that will bring the Trade Confirmation to an end.'[15]

As opposed to the *Elpida* court – and based on a different set of facts – the *Fairfield* court held that a section 363 review was not warranted because a transfer *of property in the US* under Bankruptcy Code section 1520(a)(2) was not invoked, and such ruling was 'consonant with the origins of Chapter 15 and the notion of comity, a central tenet therein.'[16] Based on the principles of justice, convenience and commons sense applicable by New York non-bankruptcy law,[17] the court held that the SIPA claim was an intangible asset located *outside of the US*, in the BVI. As the court put it, 'the transaction at issue is BVI-centric for purposes of this Court's review,'[18] and did not require plenary section 363 review.

The *Fairfield* court expressly disagreed with the *Elpida* court's 'downplay' of the role of comity in chapter 15, and, *inter alia*, criticised the questionable relevance of the number of times 'comity' appears in chapter 15 to its actual importance, which, in the *Fairfield* court's opinion, was extensively supported by the mere purpose of chapter 15 and the deferential framework for international judicial cooperation.[19] Regardless of its position on comity, however, the *Fairfield* court recognised certain key factors that critically distinguished its case from *Elpida*: (i) the asset was located outside the US, (ii) the BVI court had the paramount interest in the sale of the SIPA claim, (iii) there were no interests, such as liens or intellectual property, unique to any of the US parties, (iv) US creditors only had limited interest in the SIPA claim sale; (v) there was no court order requiring the US court to approve a sale of assets like in *Elpida*; and (vi) ultimately, recognising that it was 'a pure and simple case of seller's remorse,'[20] it was likely easier for the *Fairfield* court to defer to the BVI court's decision.

Elpida and *Fairfield* teach an important lesson: even if a chapter 15 foreign debtor's sale of assets is approved in its main foreign proceeding, an additional section 363 review by the ancillary US bankruptcy court is still likely when the assets at issue are located in the US and US creditors have particular interests in the assets. To increase this likelihood, parties in favour of a plenary section 363 review may consider following the *Elpida* precedence and require that the recognition order explicitly prohibit the foreign representatives from selling any US assets before obtaining the US court's approval.

Notes

14 Stipulation of Dismissal of Appeal with Prejudice, *In re Elpida Memory Inc.*, Case No. 12-10947 (CSS) (Bankr. D. Del. June 17, 2013) [Docket No. 440].
15 *In re Fairfield Sentry Ltd.*, 484 B.R. 615, 622 (Bankr. S.D.N.Y. 2013) (internal citations omitted).
16 *Id.*
17 The court determined that applicable non-bankruptcy law determines if an intangible interest is within the territorial jurisdiction of the US.
18 *In re Fairfield Sentry Ltd.*, 484 B.R. 615, 628 (Bankr. S.D.N.Y. 2013).
19 *Id.* at 627 (internal citations omitted).
20 *Id.* at 617.

SIP 16: Out with the Old and in with the New?

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On 1 November 2013, an updated Statement of Insolvency Practice 16 (the 'New SIP 16') was issued by the Joint Insolvency Committee. This update overrides the Statement of Insolvency Practice 16 published in 2009 (the 'Old SIP 16') and the Old SIP 16 guidelines have now been withdrawn; although it should be noted that further change is anticipated, as set out below. SIP 16 sets out the guidelines which administrators in the UK ought to adhere to when conducting a pre-packaged sale i.e. a sale of a company's business or assets on or immediately after the formal appointment of the office holder ('pre-packs').

The Old SIP 16 had been subject to criticisms such as the 'phoenix phenomenon' (the possibility that an insolvent company can effectively reform by selling the business or its assets to its original directors and/ or shareholders without any redress to its creditors); lack of transparency on consulting with creditors, valuation and the long term impact that it could have on the company.

It is questionable whether the New SIP 16 has addressed the above problems in full, as commentators believe that the New SIP 16 does not differ significantly from the Old SIP 16. The main theme for the changes is the issue of transparency throughout the pre-packaged sale process. The New SIP 16 attempts to tackle the transparency problem by providing greater clarity for creditors e.g. it requires administrators to provide earlier notification of the pre-pack and more detail on circumstances of the transaction.

A detailed analysis of changes in the relevant paragraphs and the appendix to SIP 16 are set out below.

Key changes

1. Statement of transaction

The administrator is now obligated to provide the creditors with a detailed statement and justification that the pre-pack sale process has taken the interest of the creditors into account and meets the statutory purpose set out in the Insolvency Act. The administrator also has to demonstrate that the sale price is the best price that can reasonably be achieved.

2. Seven day notification limit

The statement of transaction needs to be provided with the first notification to creditors and in any event within seven calendar days of the sale. The time limit in the Old SIP 16 was fourteen calendar days. The effect of this is that under the New SIP 16 the administrator must provide more information to the creditors, in less time. There is also a filing requirement at Companies House with the administrator's Statement of Proposal.

3. Disclosure requirements

The information disclosure requirements are more substantial than previously, placing greater emphasis on the provision of information relating to valuation. The New SIP 16 appendix enhances the list of information to be provided to creditors currently listed at paragraph 9 of the Old SIP 16. The enhancements are as follows:

a. The source of the administrator's initial introduction must now be by name and date.

b. Pre-appointment considerations must be disclosed to the extent of showing the administrator's involvement prior to the appointment and whether efforts were made to consult with major creditors and the outcome of any such consultation.

c. Details of registered charges with dates of creation and details of previous sales of the business in (at least) the previous 24 months and disclosure of any involvement by the administrator or the administrator's firm.

d. The outcome of any marketing activities conducted by the company or, where no marketing activities were undertaken, an explanation as to why this was the case.

e. A summary of the valuation methodology, together with detailed information about any valuers or advisors. Also, if no valuation has been obtained, the reason why there has not been a valuation together with an explanation as to how the administrators satisfied themselves on the value of the assets.

f. In transactions impacting on more than one related company the administrator must ensure that

the disclosure is sufficient to enable a transparent explanation (e.g. allocation of consideration paid).

g. Details of the sale consideration with terms of payment and any condition of the contract that could materially affect the consideration must be provided. Sale consideration should be broken down under valuation categories and split between fixed and floating charge realisations.

Practical implications

The New SIP 16 is an improvement in providing more structured guidance on disclosure requirements and is helpful to creditors as a whole. Administrators now need to provide more information in relation to pre-packs, within a shorter timeframe.

However, the New SIP 16 is likely to receive criticism from creditors for not addressing all problems associated with the Old SIP 16. One of the main criticisms is that the information on pre-packs will only be disclosed after the sale has completed in order to preserve the company's going concern value, whereas creditors will often wish to receive information before the transaction has taken place.

Creditors' concerns may well be addressed in the near future as the Insolvency Service is currently conducting a review of the pre-pack regime. A report is expected in Spring 2014 and there is a real possibility that SIP 16 may be further revised as a result and therefore the New SIP 16 may merely be, a stopgap solution.

Ricoh Europe Holdings BV and others v Spratt and another, Compromising Contingent Creditors

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Introduction

On 19 February 2013 judgment was handed down in *Ricoh Europe Holdings BV and others v Spratt and another.*[1] Lord Justice Patten (who gave the leading judgment), Lord Justice Mummery and Lord Justice Treacy, sitting in the Court of Appeal, (the 'Court of Appeal'), rejected an appeal by a contingent creditor to force a liquidator, in a solvent liquidation, to make full provision for the creditor's claim (so that the claim would be paid in full when it crystallised) rather than a lower current value being attributed to the contingent claim by the liquidator under the Insolvency Rules 1986 (as amended) ('IR 1986').

The Court held that there was a comprehensive mechanism contained in the IR 1986 to resolve contingent claims and the Court would not interfere with a liquidator that had applied the procedure in the IR 1986 correctly in respect of the valuation of contingent claims.

The determination of contingent claims

A contingent claim is a claim that, at the time a company entered into liquidation, was not certain. In the Ricoh case it was a claim under an indemnity in respect of tax liabilities which needed to be investigated and audited before a final value could be given to each liability.

A proof of debt for a claim in a liquidation must set out the value of a claim as at the point in time at which the company in question went into liquidation.[2] In the current case it was difficult for the claimant to insert a value in the proof of debt because the claim was contingent upon the occurrence of the tax audits and investigations.

As such, a contingent claim shall be valued pursuant to Rule 4.86 of the IR 1986. Rule 4.86 states that, '… a liquidator shall estimate the value of any debt which, by reason of its being subject to any contingency or for any other reason, does not bear certain value …'.[3] This gives a liquidator the power to estimate the final value of a creditor's claim and inform the creditor of that valuation. The liquidator may also revise his estimate at any time during the liquidation process. This estimated value then becomes the value of the creditor's claim for the purposes of receiving a distribution in the liquidation.[4]

Ricoh Europe Holdings BV – the facts

The Ricoh group of companies ('Ricoh') acquired the Infotec group ('Infotec') from Danka Business Systems Plc ('Danka') in 2007. As part of the acquisition of Infotec, Danka agreed to indemnify Ricoh, in full, against a number of pre-completion tax liabilities of the Infotec companies in Germany, France, Italy and Spain.

In February 2009 Danka commenced a member's voluntary liquidation ('MVL') under section 91 of the Insolvency Act 1986 (as amended) ('IA 1986'). At the point of liquidation, Ricoh had both certain and contingent claims under the tax indemnities given by Danka in respect of the acquisition of Infotec. In certain jurisdictions, such as Italy, the quantification of the claim depended on the outcome of a tax audit or, an investigation by the relevant Italian revenue authority.

In March 2009 the liquidators of Danka issued a notice to creditors pursuant to Rule 4.182A, IR 1986 informing them that they proposed to make a final distribution to creditors and required that all proofs of debt were submitted by 28 April 2009. Ricoh responded by letter setting out the tax liabilities and its estimate of the maximum possible value of its contingent claims. Ricoh's letter also requested that the liquidators deferred taking any further action in the liquidation until the claims could be quantified by the various tax audits and investigations. The letter finally requested that

Notes

1 [2013] EWCA Civ 92.
2 Rule 4.75(1)(b) Insolvency Rules 1986 (as amended).
3 Rule 4.86(1) Insolvency Rules 1986 (as amended).
4 Rule 4.86(2) Insolvency Rules 1986 (as amended).

the liquidators should 'ring fence' a sufficiently large reserve prior to distributions to creditors and members out of which the contingent claims, once crystallised, could be paid.

The liquidator's response to Ricoh was to state that it was not necessary to wait for the tax liabilities to crystallise and that any contingent claims could be correctly valued under Rule 4.86 IR 1986. However, one of the main issues was the wide disparity between the liquidator's and Ricoh's initial valuation of the tax liabilities. Ricoh valued the worst case scenario at EUR 11,886,695, whilst the liquidators estimated the value of the claim to be EUR 268,961.

High Court hearing

This disparity led Ricoh to issue an application in April 2010 seeking a direction under section 112 IA 1986 that the liquidators should reserve for the full EUR 11,886,695. The matter did not come before the High Court until March 2012 by which point various investigations and audits had been carried out and the disparity between amounts had reduced somewhat with Ricoh now only seeking a reserve of EUR 1,879,746.

Ricoh submitted that Danka had provided a full indemnity and that it would be inequitable for Danka to avoid the payment of this liability by means of an MVL. Ricoh further relied on the argument that the reserve should be made on the basis that creditors being paid in full was an integral part of the MVL process.

High Court decision

The High Court was sympathetic to Ricoh's arguments but held that once a contingent creditor had proved in the liquidation for its debts and such debts had been valued, there was no flexibility in the MVL process (as prescribed by the IA 1986) to allow a liquidator to delay the distributions to allow for the contingent creditor's claims to crystallise. Ricoh appealed the decision.

Points raised on appeal

Ricoh raised several arguments on appeal, which were:

(1) the liquidators were not under any obligation to value the contingent claims at the time the proof of debt was submitted and make a distribution at that time based on those valuations; instead, Ricoh submitted that the liquidators should delay the declaration of a dividend until the completion of the various tax audits and investigations;

(2) the liquidators had a discretion under the IA 1986 to delay a declaration of a dividend; and

(3) the liquidators should have estimated Ricoh's claim using the total contingent liability claimed by Ricoh and therefore protect Ricoh against a loss of a commercial benefit (in this instance a tax indemnity).

Ricoh sought to rely on the decision of Sir Robert Megarry V-C in *Re R-R Realisations Ltd* (the 'R-R Case')[5] which led to the formulation of Rule 4.128A IR 1986. In summary the R-R Case involved a situation in which the liquidators of the company, having paid all known creditors, sought to make a distribution to the shareholders. The liquidators made an application but were refused following a late claim by a creditor. A key factor in Megarry V-C's decision to delay distributions was that the distribution was to be made to shareholders but a claim by a creditor, albeit late, should be addressed by the liquidators before making such distributions to shareholders.

Ricoh sort to use the judgment of Megarry to show that a liquidator was always under a duty to carry out the process of a liquidation with diligence and efficiency but also with an overriding objective to be fair to all creditors of the company in question. Therefore, in order to fulfil that overriding objective the liquidators of Danka should wait for the finalisation of the tax audits and investigations.

Court of Appeal's decision

The Court of Appeal unanimously dismissed the appeal by Ricoh.

In respect of the first of Ricoh's arguments the Court of Appeal did not agree that the R-R Case supported the arguments of Ricoh as the R-R Case was concerned with late claims which were not relevant in the case as Ricoh had proved for its contingent claims in a timely manner and in response to the Rule 4.128A notice (and the claims had been valued). Therefore, Ricoh had submitted to the process under the IR 1986.

The Court of Appeal stated that the actual issue in this case was the process that should be undertaken by the liquidators in processing contingent claims that have been proved for and valued by the liquidators. The Court cited and relied on the decision in *Re House Property and Investment Co Ltd*[6] in which the landlord

Notes

5 [1980] 1 WLR 805.
6 [1954]1 Ch 576.

of commercial premises applied to the High Court for an order that the liquidator of the tenant set aside a reserve, and was refused by the High Court on the basis that the landlord should follow the proper procedure of a liquidation and lodge a proof of debt claim.

The Court of Appeal held that the process set out under Rule 4.86, IR 1986 was a comprehensive procedure that neither required nor imposed a duty on the liquidators to create a retention fund to satisfy Ricoh's claim.

In respect to Ricoh's second argument, the Court did concede that there may be circumstances in which it would be appropriate for a liquidator to delay a distribution of assets but only where the determination of the contingent liability was imminent. However, in this case the determination of the tax liabilities would not have actually occurred until after the contractual tax indemnity period expired in 2014.

In respect of the third argument raised by Ricoh, the Court of Appeal stated that whilst it accepted that the valuation of the liquidators did have the practical effect of not allowing Ricoh to gain the full benefit of the contracted tax indemnity it did allow the liquidation to proceed as efficiently as possible. The process of valuation prevents a contingent liability holding up the process of a liquidation and the Court held that the valuation undertaken by the liquidators in the case at hand was correct and the nature of the liability was irrelevant to a liquidator's assessment of the underlying contingent claim.

Comment

The Court's decision sets a clear precedent that an MVL can have the effect of compromising a contingent claim against a company which is somewhat contrary to the widely held perception that an MVL is a process under which all creditors are repaid in full. Whilst the decision of the Court of Appeal simply followed the decisions that preceded it, it is the first express statement by the High Court and Court of Appeal that a liquidator under an MVL does not have any greater flexibility than a liquidator under a CVL.

It also provides clear guidance on the fact that there is no obligation on the liquidator in an MVL to establish a retention fund for those claims by creditors which are contingent.

However, the Court did not provide certainty on a liquidator's ability to create a reserve where a contingent claim was to be determined imminently. Whilst the Court of Appeal expressed its doubts as to a liquidator's ability to create a reserve in these circumstances, the decision does not restrict a liquidator seeking a direction on this point at a later date in a case where this may be of relevance.

It would appear that the opinion of the Court of Appeal that the liquidators of Danka had correctly valued Ricoh's contingent claims in accordance with the IR 1986 was the fundamental factor in the Court of Appeal's decision.

Under Pressure: *Ebbvale Limited v Andrew Lawrence Hosking (Trustee in Bankruptcy of Andreas Sofroniou Michaelides)* [2013] UKPC 1

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Introduction

In many common law jurisdictions a winding up petition is a potent threat against a company, particularly where the petition is required to be advertised and damaging publicity for the company will ensue. In England and Wales, for example, the procedure set out in the Insolvency Rules 1986 requires a petitioning creditor to give notice of a petition by placing an advertisement in the London Gazette, not less than seven business days after service of the petition and not less than seven business days before the winding up hearing.[1] It is obvious that any company, particularly one that may already be in financial difficulty, will urgently seek to prevent the creditor from presenting the petition, or at least from advertising it. The simplest and most cost-effective way of doing so is for the company to pay or compromise the debt. A petition can therefore be a useful weapon to a creditor who wishes to apply pressure on a company to pay, even where that creditor is not necessarily interested in winding up the company per se.

If a company cannot or will not pay or compromise the debt it will usually, if possible, apply to the court for injunctive relief to prevent presentation or advertisement of the petition.[2] Where a company faces a winding up petition that has been, or appears to have been, presented with an ulterior motive or collateral purpose, the company may seek to dismiss the petition as an abuse of process. What constitutes an abuse of process in this context is the subject of a canon of case law to which the UK Privy Council judgment in *Ebbvale* has recently been added.

Ebbvale is particularly interesting to practitioners from a cross-border perspective as it concerned concurrent proceedings in England and the Bahamas, where it was claimed that a winding up petition presented against a Bahamian company under Bahamian law was in fact a tactic to gain an advantage in the English proceedings against the same company and thus amounted to an abuse of process.

The English proceedings

On 21 December 2000 Mr. Andreas Michaelides (the 'Debtor') was adjudicated bankrupt in England and Wales and Mr. Andrew Hosking, a licensed Insolvency Practitioner and member of Grant Thornton UK LLP, was appointed his trustee in bankruptcy (the 'Trustee').[3] The Debtor had been the registered owner of a substantial property in London, Sunnyside Service Station ('Sunnyside'), a petrol station with development potential and, according to some valuations, worth several million pounds. Two days before being adjudicated bankrupt the Debtor had transferred Sunnyside, allegedly to two brothers named Andreou, who became the registered owners.

The Trustee investigated the transaction and concluded that the Andreou brothers did not exist, or in any case had not genuinely acquired Sunnyside, and that true economic ownership of Sunnyside remained with the Debtor until vesting in the Trustee himself on the Debtor's bankruptcy. The Trustee registered a caution against Sunnyside in August 2001 at the Land Registry and commenced proceedings for a declaration that, if the Andreou brothers did indeed exist, they held Sunnyside on a bare trust for the Trustee and that the Land Register be rectified to show the Trustee as owner. The Andreou brothers, if in fact they did exist, took no part in the proceedings.

Sunnyside was purported to have been transferred by the Andreou brothers to an International Business Company incorporated in the Bahamas named Ebbvale Limited (the 'Company') for a purchase price

Notes

1 Insolvency Rules 1986, Rule 4.11.
2 For example, in England and Wales an injunction would be sought under Rule 4.6A Insolvency Rules 1986.
3 During the course of the bankruptcy Mr. Hosking ceased to be a member of Grant Thornton and was in fact replaced as the Trustee by another member before the Privy Council hearing. This was raised as a point at the hearing, but was dealt with separately in the judgment and is not relevant for the purposes of this article.

of GBP 750,000. National Westminster Bank plc (the 'Bank') loaned the Company GBP 450,000 of which GBP 380,000 was advanced towards the purchase of Sunnyside, which was to be mortgaged to the Bank.

The Trustee formed the view that the Company was also under the effective control of the Debtor. As a result of the caution registered by the Trustee, the Company had not been able to register its title to Sunnyside, nor had the Bank been able to register its mortgage over Sunnyside. The Trustee named both the Company and the Bank as further defendants to his claim for title to Sunnyside which commenced in December 2003.[4]

The Trustee subsequently settled his claim against the Bank. In consideration for payments made to the Bank by the Trustee (in the amount of GBP 80,000) and by the solicitors who had previously represented the Company (in the amount of GBP 295,000) the Bank assigned to the Trustee on 5 October 2007 the Company's debt of GBP 450,000 plus interest (the 'Debt') and the purported mortgage over Sunnyside. The Company was left as the only active defendant to the English proceedings.

The Bahamian proceedings

In March 2008 the Trustee served a statutory demand on the Company at its registered office in Nassau for payment of the Debt. The Company did not dispute liability, but neither did it comply with the statutory demand and the Trustee presented a winding up petition to the Bahamian Supreme Court on 9 June 2008.

In the Bahamian winding up proceedings the Trustee maintained that:

- Further interest was accruing on the Debt and was not being paid;
- If the Trustee were successful in his claim to ownership of Sunnyside in the English proceedings then the Debt would be left unsecured; and
- The Trustee was incurring substantial costs in the English proceedings, but any costs order in the Trustee's favour, if successful, could not be enforced against the Company as it would then have no substantial assets. The Company therefore had an unfair advantage in defending the English proceedings.

The Company opposed the winding up petition on the basis that the Trustee had an improper purpose in presenting the petition so as to render it an abuse of process, apparently encouraged in its view by comments of David Richards J in an interim application in the English proceedings (despite Richards J stating that his words were not intended to pre-empt the outcome of that hearing).

Richards J had noted that:

- The Trustee's presentation of the petition was obviously designed to secure a strategic advantage in the English proceedings;
- The appointment of a liquidator to the Company might force an adjournment of the English proceedings (that the Trustee had been seeking in the interim application) to which the Trustee was not entitled; and
- The Trustee might be able to achieve a more favourable settlement of the English proceedings if the Company's defence were being conducted by a liquidator.

In a first instance judgment of the Bahamian Supreme Court, Commercial Division dated 28 August 2008, Lyons SJ ordered that the Company be wound up, noting that any advantage gained by the Trustee in the English proceedings as a result of the winding up would not be unfair. The judge also noted that if a Bahamian liquidator and the Trustee, both officers of the court, reached a settlement it was unrealistic to consider that such a settlement would be unfairly prejudicial to the Company.

The Company appealed to the Bahamian Court of Appeal, which upheld the order of Lyons SJ for the reasons he had given. A subsequent appeal to the Privy Council was heard on 12 July 2012. The Privy Council's decision was handed down on 31 January 2013 with Wilson LJ providing the leading judgment.

The Privy Council decision

Wilson LJ set out the general premise from *In re Amalgamated properties of Rhodesia (1913) Ltd* that only the very strongest proof of improper ulterior motive will displace a creditor's entitlement to a winding up order.[5]

The judge considered authorities that had been raised by the Company in relation to nineteenth century cases concerning creditors abusing the court process by presenting a winding up petition not in order to obtain a winding up order, but to put the debtor under pressure.[6] He also examined two cases from the

Notes

4 The proceedings commenced in December 2003 were stayed pending criminal fraud proceedings brought against the Debtor in relation to Sunnyside of which the Debtor was acquitted during the spring of 2007.

5 [1917] 2 Ch 115.

6 In particular *In re A Company* [1894] 2 Ch 349.

1960s, quoting from one of them the dictum that a petition launched with the objective of exerting pressure to achieve a collateral purpose rather than with the genuine object of obtaining a winding up order is an abuse of court process.[7]

Wilson LJ noted that the Trustee clearly did genuinely intend to wind up the Company and that the authorities raised in relation to a position where it is not in fact the petitioner's purpose to wind up the debtor company did not apply.

The Company's defence therefore could only rely on the decision in *In re a company,*[8] in which Harman J had refused a winding up order as an abuse of process in circumstances where the petitioner had in fact intended to wind up the debtor company.

As Wilson LJ observed, the circumstances in *In re a company* were highly unusual. The debtor company's major asset was the lease of a site in Southern Scotland, from which the company conducted its business by recovering coal from that site. Under Scots law the lease contained an 'irritation' clause that effectively allowed the lease to be forfeited (in English terms) if a petition to wind up the company was presented.

One of the company's creditors negotiated with the company's landlord to be granted a new lease of the site by the landlord if that creditor presented a petition against the company by a certain date. That creditor then issued a statutory demand against the company, despite the informal agreement between the company's (substantial) other creditors to allow the company a breathing space in order to realise assets or raise money.

The company commenced proceedings to resist the statutory demand, but which were dismissed with costs. The day before the order for costs was made the company paid the outstanding debt in full. The next day the creditor, on being awarded costs in the proceedings in the morning, presented a winding up petition against the company in the afternoon on the basis of its unpaid (and at that stage unassessed) costs.

In giving judgment in *In re a company*, Harman J observed that the true position of a creditor seeking to wind up a company was that of a party 'invoking a class right on behalf of himself and all others of his class'. It followed that the motive of the petitioning creditor was immaterial to whether the petition had been made for an improper purpose and that the only relevant question was whether the purpose of the winding up was for the benefit of the class to which the petitioner belonged or whether it was for some purpose of the petitioner's own.

Harman J dismissed the petition in *In re a company* as an abuse of court process on the basis that, even though the petitioning creditor did genuinely wish to wind up the company, it did so in order to gain a valuable asset for itself at the expense of the other creditors (although he also ruled that it was unacceptable to present a petition in respect of an unascertained debt, which the debtor had had no opportunity to repay).

Wilson LJ noted that the Trustee's stated purpose in seeking the winding up had been to vest direction of the Company's defence to the English proceedings in a liquidator, but that a liquidator would direct the defence in line with the Company's true interests, which would have a beneficial effect on all genuine creditors and contributories of the Company.

The Privy Council found that the Bahamian liquidator who had been appointed to the Company was a very experienced professional, unconnected with the Trustee,[9] and concluded that:

- The merits of the English proceedings were irrelevant, although the purpose of the petition was intimately related to them;
- It was likely that the Trustee regarded a winding up order as advantageous to him as claimant in the English proceedings because the Company's defence was generating a growing potential liability for him in relation to costs incurred and the corresponding risk that such costs could not be met;
- It was objectively likely that the Trustee regarded a winding up order as advantageous to him as petitioning creditor in the Bahamas and to secure such advantage was one of his purposes. It was not necessary that it should have been his principal purpose; and
- It was in the interests of both the Trustee, as a large unsecured creditor of the Company without even being in receipt of interest, and in the interests of the Company itself, prior to incurring further indebtedness in respect of the costs of the English proceedings, that a professional decision should be taken regarding the proceedings and any compromise.

The Privy Council therefore held that the Trustee's petition was not an abuse of court process and declined to overturn the winding up order.

Notes

7 *Re Bellador Silk Ltd* [1965] 1 All RE 667.

8 [1985] BCLC 492.

9 In contrast to *In re Wallace Smith & Co Ltd* [1992] BCLC 970, where a winding up petition was refused to liquidators of another company who sought to be appointed over the debtor company also, which would have given rise to a conflict of interest in Canadian proceedings brought by the same liquidators against the same debtor company.

Conclusion

The Privy Council was satisfied that, where a creditor presents a petition in respect of a debtor company and its purpose is to wind up that company, it is not necessary that the winding up is the creditor's sole or even main purpose, and motive is irrelevant. The winding up must simply be advantageous to the creditor in his capacity as a member of a class of creditors. The decision therefore clarifies the extent to which a creditor can, without abusing the process of the court, serve a winding up petition to put a debtor company under pressure.

ABC Learning: The ABC of Chapter 15 is to Rely on Its Plain Meaning

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In its first decision in a chapter 15 matter, the United States Court of Appeals for the Third Circuit ('Court of Appeals') found that (i) an Australian liquidation proceeding was eligible for recognition as main foreign proceeding under chapter 15, even if a concurrent receivership that effectively controlled all the debtor's assets did not meet requirements for recognition, and (ii) the automatic stay protected the foreign debtor's assets located in the United States, even when they were fully encumbered.

I. Background

ABC Learning Centres Ltd. ('ABC') is a publicly traded Australian company that provided child care and educational services in Australia and other countries. In November 2008, ABC directors entered into voluntary administration under Australian law, pursuant to which administrators were appointed to determine whether the company could be reorganised, or whether liquidation was necessary. The initiation of voluntary administration proceedings breached ABC's loan agreements with its secured creditors and triggered their right to initiate a receivership process to realise their assets. Notably, all ABC's assets were encumbered by the secured creditors' liens. On 2 June 2010, ABC's directors decided to enter into liquidation and appointed two liquidators to wind up the company. The liquidation and the receivership ran concurrently.

In the United States, the company operated through its subsidiaries, ABC Developmental Learning Centres (USA) Inc. ('ABC Delaware') and the Learning Care Group. In June 2008, ABC Delaware contracted with RCS Capital Development LLC ('RCS') to develop child care facilities in the United States. Subsequently, RCS sued ABC Delaware on a breach of contract claim in Arizona state court, and won a USD 47 million verdict on 14 May 2010 ('Arizona Verdict'). In another lawsuit, pending in Nevada, ABC and ABC Delaware sued RCS for USD 30 million ('Nevada Lawsuit').

On 26 May 2010, before the Arizona Verdict was rendered into judgment, the liquidators filed a petition for recognition under chapter 15 in the United States Bankruptcy Court for the District of Delaware (the 'Bankruptcy Court'). The Bankruptcy Court granted recognition of the Australian liquidation as foreign main proceeding and imposed the automatic stay of actions against ABC and its property in the United States, which was modified to allow RCS to render the Arizona Verdict into judgment and apply it as a defence in the Nevada Lawsuit. RCS appealed the recognition, but the district court upheld the Bankruptcy Court's orders. RCS further appealed to the Court of Appeals.

II. A foreign liquidation proceeding is not precluded from recognition as foreign main proceeding merely because secured creditors may realise their interest through a separate proceeding that does not meet requirements for recognition

Under Australian law, receivership and liquidation can proceed at the same time. While receivership realises assets for the benefit of secured creditors only, liquidators represent the interests of all creditors and distribute any assets available after secured creditors have been made whole. However, the two proceedings are not completely independent one from the other. The liquidator may (i) review the appointment of the receiver; (ii) monitor the progress of receivership; and (iii) investigate and challenge secured creditors' claims. In addition, receivership is not mandatory: secured creditors can elect to surrender secured assets to liquidators and participate in distributions through the liquidation. Whether secured assets are realised in the receivership or liquidation, any surplus realised above the amount of debt owed to secured creditors is available for distribution to the unsecured creditors.[1]

Notes

1 *See, generally*, Australia's Corporations Act.

In ABC, the value of all its assets was encumbered by the secured creditors' claims. Effectively, this left little to no assets available to unsecured creditors, and minimised the liquidators' role to investigation of the secured creditors' claims. Based on this factual background, RCS argued that recognition of the liquidation proceeding only benefitted the receivership, which, however, did not meet the requirements for recognition because it was not a collective proceeding representing all creditors. RCS contended that benefitting the receivership would contravene United States public policy,[2] which is in favor of collective insolvency proceedings.

The Court of Appeals, however, was not persuaded by RCS' argument and strictly relied on the language of the statute,[3] which does not provide 'any exception to recognition based on the debtor's debt to value ratio at the time of insolvency'.[4] The Court of Appeals concluded that such 'exception could contravene the stated purpose of Chapter 15 and the mandatory language of Chapter 15 recognition'.[5] Following the narrow interpretation of the public policy exception applied in previous decisions, the Court of Appeals found the Australian liquidation proceedings did not violate United States' public policy merely because they exempted secured creditors from surrendering their interests to the liquidation proceeding.[6] The Court of Appeals noted the public policy of collective proceedings was meant 'to provide an orderly liquidation procedure under which all creditors are treated equally,'[7] and the Australian liquidation met this requirement. By contrast, RCS, an unsecured creditor, sought to evade orderly liquidation and 'skip the line' by seeking to attach ABC's assets before any other creditor could get to them. In addition, the Court of Appeals noted the Australian insolvency system did not differ much from the United States' system. While Australian law allowed secured creditors to realise assets in their own proceeding outside of liquidation, secured creditors in the United States normally retrieved value through a unified bankruptcy proceeding – an option available to secured creditors in Australia, as well.[8] Despite the different method, the priority of payment remains the same: secured creditors are repaid before unsecured creditors.

III. Even though fully encumbered, ABC's property was still 'property of the debtor'

Upon recognition of a foreign main proceeding, the automatic stay applies with respect to the debtor and the property of the debtor that is within the territorial jurisdiction of the United States.[9] RCS argued that ABC's assets in the United States were not 'property of the debtor' because the assets were fully encumbered, and Bankruptcy Code section 541 (which defines 'property of the estate') excludes assets in which the debtor holds bare legal title without equitable interest.[10]

The Court of Appeals rejected this argument. First, ABC did retain certain equitable interests in the encumbered property because: (i) any surplus over the value of the secured lenders' liens belonged to ABC and its unsecured creditors; (ii) ABC retained the right to redeem the assets; and (iii) the liquidator had the ability to challenge the secured creditors' claims. Second, the definition of 'property of the estate' in section 541 is not relevant to the definition of 'property of the debtor' in chapter 15. Recognition of a foreign proceeding does not create a bankruptcy estate, because Bankruptcy Code section 541[11] is not among the sections

Notes

2 Notably, section 1506 of the Bankruptcy Code provides for a public policy exception, which allows courts to refuse to take an action under chapter 15 if such action would be manifestly contrary to the public policy of the United States.

3 Subject to section 1506, after notice and a hearing, an order recognising a foreign proceeding shall be entered if--
(1) such foreign proceeding for which recognition is sought is a foreign main proceeding or foreign nonmain proceeding within the meaning of section 1502;
(2) the foreign representative applying for recognition is a person or body; and
(3) the petition meets the requirements of section 1515.
11 U.S.C. §1517(a).

4 *In re ABC Learning Centres Ltd.*, 2013 U.S. App. LEXIS 17844, at *17 (3d Cir. Aug. 27, 2013).

5 *Id.*

6 In *In re Schimmelpenninck*, 183 F.3d 347, 365 (5th Cir. 1999), the United States Court of Appeals for the Fifth Circuit held that a Dutch proceeding that did not obligate secured creditors to realise their assets through a liquidation proceeding was not 'repugnant to [U.S.] law and policies'.

7 *In re Schimmelpenninck*, 183 F.3d at 351 (quoting H.R. Rep. No. 95-595, 1st Sess., at 340 (1977)).

8 As noted above, secured creditors in Australia may elect surrender assets to the liquidator and to take part in distribution administered by liquidators.

9 *See* 11 U.S.C. §1520(a).

10 Section 541(d) provides:
Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.
11 U.S.C. §541(d).

11 Section 541(a) provides, among other things, that '[t]he commencement of a case under section 301, 302, or 303 of this title creates an estate.' 11 U.S.C. §541(a).

that become effective upon recognition.[12] Instead, the determination of property of the debtor is made under the law of the place where the main proceeding is pending.[13] Under Australian law, ABC retained 'several equitable interests in the property'.[14]

IV. Conclusion

The ABC decision continues a trend envisioned by chapter 15 and the international foundations it was built on: greater legal certainty and predictability. By narrowly applying the language of chapter 15 without expanding or modifying the meaning of the requirements for recognition, property of the debtor, and the public policy exception, the decision provides additional reassurance and clarity to prospective chapter 15 debtors.

Notes

12 *In re Qimonda AG*, 482 B.R. 879, 887 (Bankr. E.D. Va. 2012) ('Upon recognition of a foreign main proceeding, an estate is not created, as Section 541 of the Bankruptcy Code is not among the enumerated Sections of the Bankruptcy Code that become operative upon recognition under Section 1520.').

13 *In re Lee,* 472 B.R. 156, 178 (Bankr. D. Mass. 2012) ("[N]either section 541(a) nor 541(c)(1) are applicable to a determination of property of the Hong Kong bankruptcy estates, and the determination of property of the estates must be made under Hong Kong law.")

14 *In re ABC Learning Centres Ltd.*, 2013 U.S. App. LEXIS 17844, at *29.

Barnet Raises the Bar for Chapter 15 Recognition in the Second Circuit

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In *In re Barnet*,[1] the United States Court of Appeals for the Second Circuit ('Court of Appeals') imposed a new hurdle for foreign debtors seeking chapter 15 recognition. In addition to the requirements for recognition of a foreign proceeding set out in chapter 15, a foreign debtor must now also show it has a residence, domicile, place of business or assets located in the United States, as required for debtors under the Bankruptcy Code by section 109(a). The *Barnet* decision, however, should not have a chilling effect on foreign debtors considering chapter 15. First, changing venue may be an option: the United States Bankruptcy Court for the District of Delaware disagreed with the conclusion in *Barnet* and opined the United States Court of Appeals for the Third Circuit would likely not follow *Barnet* either.[2] Second, changing venue should not be necessary where foreign debtors can show they have even nominal assets in the United States, since minimum presence in the United States normally suffices to overcome the burden of section 109(a).

1. Background[3]

Octaviar Administration Pty Ltd. ('Octaviar'), an Australian company, was placed into external administration in Australia on 3 October 2008. About a year later, the Supreme Court of Queensland ordered Octaviar be liquidated. On 13 August 2012, Octaviar's foreign representatives filed a petition for recognition as a foreign main proceeding with the Bankruptcy Court for the Southern District of New York. The foreign representatives stated Octaviar did not transact business, have any operations or creditors in the United States, but they were seeking chapter 15 recognition to investigate potential claims and causes of action against entities located in the United States.[4] The recognition order was entered on 6 September 2012, over the objection of Drawbridge Special Opportunities Fund LP ('Drawbridge').[5] Drawbridge appealed.

2. A foreign debtor must have a domicile, place of business, or property in the United States to be eligible for chapter 15 – at least in the Second Circuit

The Court of Appeals considered whether the eligibility requirement of Bankruptcy Code section 109(a) – that a debtor under the Bankruptcy Code have a domicile, a place of business, or property in the United States – applies to a debtor in chapter 15 proceedings.[6]

A case under chapter 15 of the Bankruptcy Code is commenced by a foreign representative filing a petition for recognition under section 1515. The requirements for recognition are straightforward: (i) a proceeding must be a foreign main proceeding or a foreign nonmain proceeding; (ii) the foreign representative applying for recognition is a person or a body; and (iii) the petition for recognition must comply with certain procedural requirements set forth in section 1515.[7] Chapter 15

Notes

1 *Barnet v. Fletcher (In re Barnet)*, 737 F.3d 238 (2d Cir. 2013).

2 *In re Bemarmara Consulting A.S.*, Case No. 13-13037 (KG), Transcript of Hearing at 8:14-25, 9:1-18 (Bankr. D. Del. Dec. 17, 2013).

3 *See Barnet*, 737 F.3d at 241 for reference.

4 Verified Petition, *In re Petition of Katherine Elizabeth Barnet and William John Fletcher, as Liquidators of Octaviar Administration Pty Ltd*, Case No. 12-13443 (Bankr. S.D.N.Y. Aug. 13, 2012) [Docket No. 2], at ¶¶ 36-37.

5 Drawbridge's various affiliates were investigated in Australia as part of the investigation in Octaviar's affairs, and after recognition, the foreign representatives filed a motion seeking discovery from Drawbridge, among others. *Barnet*, 737 F.3d at 241.

6 Bankruptcy Code section 109(a) provides: "Notwithstanding any other provision of this section, only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title."

7 11 U.S.C. 1517(a). A petition for recognition must be accompanied by (i) a certified copy of the decision commencing such foreign proceeding and appointing the foreign representative; (ii) a certificate from the foreign court affirming the existence of such foreign proceeding and of the appointment of the foreign representative; or (iii) in the absence of the aforementioned evidence, any other evidence acceptable to the court of the existence of such foreign proceeding and of the appointment of the foreign representative. The petition for recognition must also be accompanied by a statement identifying all foreign proceedings with respect to the debtor that are known to the foreign representative. All the documents must be translated into English, and are presumed to be authentic in the absence of evidence to the contrary. 11 U.S.C. § 1515(b).

does not expressly require that a foreign debtor have assets in the United States. However, Bankruptcy Code section 103(a) provides that chapter 1, which includes section 109(a), applies to cases under chapter 15. The Court of Appeals was satisfied that the plain language of these sections made it abundantly clear the asset requirement of section 109(a) applies to a debtor under chapter 15.

The foreign representatives presented the following arguments against application of section 109(a) to a foreign debtor:

a) Section 109(a) creates a requirement for debtors under the Bankruptcy Code, while Octaviar was a debtor under Australian law, and it was actually the foreign representatives who were seeking recognition, not the foreign debtor. The Court of Appeals rejected this argument by finding that 'the presence of a debtor is inextricably intertwined with the very nature of Chapter 15', and citing the many references to 'debtor' in or related to chapter 15.[8]

b) Even if Octaviar were a debtor under the Bankruptcy Code, it is only required to meet the chapter 15-specific, section 1502 definition of 'debtor', which 'means an *entity that is the subject of a foreign proceeding*'.[9] The Court of Appeals dismissed this argument by emphasizing that section 103(a) makes section 109(a) applicable to chapter 15. In addition, the definition of section 1502 is limited to chapter 15,[10] and while it may supplant the definition of what the term debtor 'means' under title 11,[11] it cannot override requirements for 'a debtor under this title' in section 109(a) and make it inoperative.

c) Section 1528 provides that '[a]fter recognition of a foreign main proceeding, a case under another chapter of this title may be commenced *only if the debtor has assets in the United States*.'[12] Therefore, chapter 15 envisions the possibility that a foreign debtor whose foreign proceeding is recognized in chapter 15 has no assets in the United States. The Court of Appeals responded that section 1528 is more restrictive than section 109(a), which requires either 'a domicile, a place of business, or property in the United States.' Therefore, the application of both sections was not contradictory or disharmonious.[13]

d) 28 U.S.C. § 1410, which governs venue of chapter 15 cases, provides for a venue even when 'the *debtor does not have a place of business or assets in the United States*.'[14] While finding this argument to 'come closer to the mark', the Court of Appeals held the 'substantive and restrictive language' of sections 103 and 109 was controlling, because the venue statute was merely 'procedural'.[15]

e) The purpose of chapter 15 would be undermined by adding the requirement that a foreign debtor have a domicile, a place of business, or property in the United States. The Court of Appeals reviewed the purpose section of chapter 15 and the Model Law[16] and concluded that (i) the imposition of the section 109(a) requirement would not affect any of the stated purposes; and (ii) while the Model Law did not contemplate such a requirement, it did allow states to modify or omit some of the Model Law's provisions. Noting that discovery in aid of foreign proceedings (which is apparently among the reasons why Octaviar's foreign representatives sought chapter 15 recognition) could have been obtained simply through 28 U.S.C. § 1782(a) rather than chapter 15, the Court of Appeals held that Congress 'may have intended to limit the relief provided by Chapter 15 because it knew that additional relief was already available outside of Chapter 15.'[17]

The Court of Appeals also noted that Congress could have excluded chapter 15 from the reach of section 109(a), but it did not even when it took action to (i) restrict the application of section 109(b) to chapter 15; and (ii) amend section 103 to state chapter 1 applies to

Notes

8 *Barnet*, 737 F.3d at 248.
9 11 U.S.C. 1502(1) (emphasis supplied).
10 Bankruptcy Code section 1502 states that '*[f]or purposes of this chapter* [a debtor] is an entity that is the subject of a foreign proceeding'. 11 U.S.C. § 1502(1) (emphasis supplied).
11 *See* 11 U.S.C. 101(13) ('The term "debtor" means ...').
12 11 U.S.C. 1528 (emphasis supplied).
13 *Barnet*, 737 F.3d at 250.
14 28 U.S.C. § 1410 provides that a case under chapter 15 may be commenced in the district court for the district (i) in which the debtor has its principal place of business or principal assets in the United States; (ii) if the debtor does not have a place of business or assets in the United States, in which there is pending against the debtor an action or proceeding in a Federal or State court; or (iii) in a case other than those specified in (i) and (ii), in which venue will be consistent with the interests of justice and the convenience of the parties, having regard to the relief sought by the foreign representative.
15 *Barnet*, 737 F.3d at 250.
16 The UNCITRAL Model Law on Cross-Border Insolvency was promulgated by the United Nations Commission on International Trade Law at its Thirtieth Session on May 12-30, 1997, UN Sales No. E.99V.3, 1999.
17 *Barnet*, 737 F.3d at 251.

chapter 15 at the time chapter 15 was enacted. Holding that the requirement of section 109(a) applies to debtors in a foreign main proceeding[18] under chapter 15, the Court of Appeals vacated the recognition order and remanded to the bankruptcy court for further proceedings.[19]

3. The new eligibility requirement should not present a barrier for foreign debtors

A mere week after the Court of Appeals' decision judge Kevin Gross of the United States Bankruptcy Court for the District of Delaware refused to apply the asset requirement of section 109(a) to a foreign debtor seeking recognition of a Czech proceeding as foreign main proceeding. Stating that the *Barnet* decision was not binding on the court, judge Gross further noted it was 'the Court's belief that there is a strong likelihood the Third Circuit, likewise, would not agree with that decision'.[20] The Delaware court argued section 109(a) does not control when (i) it relates to 'debtors', whereas recognition was sought by foreign representatives; and (ii) section 1502 defines a foreign debtor as an entity subject of a foreign proceeding without mentioning any requirement that such foreign debtor have assets in the United States.[21] According to this ruling, a foreign debtor may simply resort to the United States Bankruptcy Court for the District of Delaware to avoid any potential barriers created by section 109(a) in the bankruptcy courts in the Second Circuit.

However, changing venue may not be necessary for those inclined to file for chapter 15 in the Second Circuit, as 'courts have required only nominal amounts of property to be located in the United States, and have noted that there is "virtually no formal barrier" to having federal courts adjudicate foreign debtors' bankruptcy proceedings'.[22] For example, section 109(a) was satisfied when a debtor held a bank account with USD 194;[23] a bank account with USD 32,000 and ownership of a company in the United States;[24] and a bank account with USD 100, marketing and advertising materials, equipment on a houseboat, and conducted business through offices in the U.S.[25] Accordingly, a foreign debtor may accumulate a modest level of presence in the United States to ensure it satisfies section 109(a) to ensure its foreign proceeding can be recognized in the bankruptcy courts in the Second Circuit.

While satisfying section 109(a) may not be an issue for a foreign debtor that already has a presence in the United States, it may create a significant burden for debtors that have no assets in the United States. Namely, a foreign debtor may not have sufficient time or resources to accumulate – even minimal – assets in the United States, and there is no certainty as to whether the analysis of section 109(a) will change to take into consideration whether a foreign debtor 'manipulated' its way into a bankruptcy court by creating a presence in the United States at the eleventh hour. Until there is additional clarity on how *Barnet* will affect chapter 15 recognition in the Second Circuit, especially with respect to foreign debtors with negligible presence in the United States, a foreign debtor unwilling to risk the Second Circuit scrutiny of its section 109(a) eligibility may prefer to seek chapter 15 recognition in the bankruptcy courts of another Circuit.

Notes

18 Presumably, the reasoning of the Court of Appeals would equally make section 109(b) applicable to debtors in foreign nonmain proceedings.

19 Up to this date, the bankruptcy court has not issued any decisions following the Court of Appeals' judgment. *See In re Petition of Katherine Elizabeth Barnet and William John Fletcher, as Liquidators of Octaviar Administration Pty Ltd*, Case No. 12-13443 (Bankr. S.D.N.Y. Aug. 13, 2012).

20 *In re Bemarmara Consulting A.S.*, Case No. 13-13037 (KG), Transcript of Hearing at 8:25, 9:1-2 (Bankr. D. Del. Dec. 17, 2013).

21 *Id.* at 9:3-18.

22 *GMAM Investment Funds Trust I v. Globo Comunicacoes E Participacoes S.A. (In re Globo Comunicacoes E Participacoes S.A.)*, 317 B.R. 235 (S.D.N.Y. 2004), citing *In re Aerovias Nacionales de Colombia S.A. (In re Avianca)*, 303 B.R. 1, 9 (Bankr. S.D.N.Y. 2003) (quoting 2 L. King, Collier on Bankruptcy, P109.02[3] (15th ed. rev. 2003)); *Maxwell Communication Corp. plc v. Societe Generale plc (In re Maxwell Communication Corp.)*, 186 B.R. 807, 818-19 (S.D.N.Y. 1995), aff'd, 93 F.3d 1036 (2d Cir. 1996).

23 *In re McTague,* 198 B.R. 428, 431-32 (Bankr. W.D.N.Y. 1996).

24 *In re Globo Comunicacoes E Participacoes S.A.*, 317 B.R. 249.

25 *In re Spanish Cay Co Ltd.,* 161 B.R. 715, 721-22 (Bankr. S.D. Fla. 1993).

Bluecrest Mercantile BV v Vietnam Shipbuilding Industry Group & others [2013] EWHC 1146 (Comm)

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Summary

In *Bluecrest Mercantile BV v Vietnam Shipbuilding Industry Group & others* [2013] EWHC 1146 (comm) the High Court of England and Wales considered whether the court has jurisdiction to order a stay of proceedings brought by a creditor against a debtor to recover debt, pending the implementation of a scheme of arrangement between the debtor and its creditors.

The court held that it did have jurisdiction to order the stay of proceedings under its case management powers in Rule 3.1(2)(f) of Part 3 of the UK Civil Procedure Rules (*The Court's Case Management Powers*).

The court's discretion to grant the requested stay on proceedings pending the implementation of a scheme of arrangement was to be exercised in 'special circumstances'. On the facts, this test was satisfied as there was a reasonable prospect of a scheme of arrangement being successfully implemented by the debtor. Accordingly, the court ordered a limited stay on proceedings until the court hearing to convene a meeting of creditors to vote on the proposed scheme of arrangement had taken place.

Background

A scheme of arrangement is a process under the English Companies Act 2006 (the 'Act') which allows a company to agree a compromise or arrangement with its creditors (or any class of them) or its members. In order for a scheme of arrangement to be passed, it requires the approval of a majority in number, that represent three-quarters in value, of each class of creditor or member. If such approval is obtained, the scheme will bind all of the relevant classes of creditors or members (whether or not they voted for the scheme).

In addition, the scheme of arrangement needs to be court sanctioned, specifically by (a) the Companies Court, following an application for permission to summon a meeting of the relevant class(es) of creditors or members; and (b) a further hearing at which the court will decide whether the scheme of arrangement is sufficiently fair and equitable to be sanctioned.

Schemes of arrangement are often used as a restructuring tool by both English and non-English companies (where the non-English company is deemed to have a 'sufficient connection' with England).[1] Although schemes of arrangement are used in restructurings, the process does not provide for an automatic moratorium on enforcement of claims by creditors of the relevant debtor company and as such does not provide the debtor with protection against claims pending implementation of a scheme of arrangement.

Facts

On 24 May 2007, Vietnam Shipbuilding Industry Group ('Vinashin'), a Vietnamese state-owned company, entered into a facility agreement (the 'Facility Agreement') with Credit Suisse AG (Singapore branch) and other lenders pursuant to which a USD 600 million unsecured loan (the 'Loan') was provided to Vinashin. The Loan was repayable in ten instalments on certain dates between December 2010 and June 2015. The Facility Agreement was governed by English law and subject to the non-exclusive jurisdiction of the English courts.

The Loan documentation allowed for the original lenders to sell or assign their participation in the Loans to third parties. Bluecrest Mercantile BV ('Bluecrest') acquired a participation of USD 25 million from Credit Suisse on 7 January 2011. FMS Wertmanagement

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1 The court did not rule on the question of whether Vinashin could be subject to an English scheme of arrangement. However, Vinashin made a subsequent separate application for orders relating to the scheme of arrangement and the High Court held that, even though Vinashin was a Vietnamese company with no assets in the UK, for the purposes of a scheme of arrangement it does have a 'sufficient connection' with the UK. This decision was based on established authority which provides that a non-English company shall be deemed to have a 'sufficient connection' with England, if its finance documents are governed by English law. See *RE Rodenstock GmbH* [2012] BCC 459 and *Re Primacom Holding GmbH* [2011] EWHC 3746 (Ch) for authority.

AOR ('FMSW', together with Bluecrest, the 'Claimants') acquired its participation of USD 45 million of the Loan from DEPFA Bank plc in January 2013.

Vinashin ran into financial difficulties and was unable to pay the principal and interest due on the Loan. From late 2010, restructuring negotiations took place between Vinashin and its creditors, including the lenders under the Credit Suisse facility. Both Bluecrest and FMSW participated in the restructuring negotiations.

On 8 November 2012 Bluecrest issued proceedings against Vinashin to recover the sums due under the Facility Agreement. A defence was served by Vinashin on 7 January 2013. Bluecrest issued summary judgment proceedings on 31 January 2013 and no evidence was served in opposition. FMSW issued similar proceedings against Vinashin on 31 January 2013. Again, no defence was served and FMSW issued summary judgment proceedings on 7 March 2013. Both applications for summary judgment were listed for hearing on 19 April 2013.

Vinashin did not defend the Claimants' claims to recover the debt that they were owed under the Facility Agreement. Instead, on 28 March 2013, Vinashin wrote to the Claimants and requested a stay of proceedings. The Claimants did not agree to the stay and as a result Vinashin applied for a stay of proceedings on 11 April 2013.

Issues

In considering Vinashin's application to stay the proceedings which had been issued by the Claimants against Vinashin for recovery of debt, the court had to decide:

(a) whether the court has jurisdiction to stay the proceedings brought by the Claimants so as to allow time for the scheme of arrangement to be put in place; and

(b) if the court does have such jurisdiction, whether it should grant the requested stay on proceedings.

Jurisdiction

Vinashin was seeking an order to stay proceedings under CPR 3.1(2)(f) of the UK's Civil Procedure Rules which gives a court power to 'stay the whole or part of any proceedings or judgment either generally or until a specified date or event'. The Claimants argued that the cases of *Booth v Waltons Manufacturing Co* [1909] 2 KB 369 and *Bowkett v Fullers United Electric Works* [1923] 1 KB 161 provided authority for the position that the court did not have jurisdiction to order a stay of proceedings pending the implementation of a scheme of arrangement. Blair J. held that the court did in fact have jurisdiction under its case management powers in CPR 3.1(2)(f) to order a stay of proceedings and distinguished *Booth* and *Bowkett* on the basis that in those cases, the court held it did not have jurisdiction to stay proceedings under the Companies Act and Insolvency Act which were applicable in those instances. Those cases did not consider the court's case management powers under Rule 3 of the UK Civil Procedure Rules.

As the court had determined that it had jurisdiction to order the stay, the court went on to consider the question of whether it should, on the facts of this case, grant the stay which was being requested.

Stay on proceedings

The court granted a limited stay on each of the Claimant's proceedings until the first scheme of arrangement hearing had taken place.

Blair J. considered the principles set out in the case of *Roberts Petroleum Ltd v Kenny Ltd* [1982] 1 WLR 301. *Roberts* considered whether the court should exercise its discretion to stay the enforcement of a judgment pending the implementation of a scheme of arrangement. Lord Brandon stated that the following circumstances would generally justify the court in exercising its discretion to stay the enforcement of a judgment:

i) the fact that the judgment debtor is insolvent;

ii) if a scheme of arrangement has been set on foot for the main body of creditors; and

iii) that scheme of arrangement has a reasonable prospect of succeeding.

Whether these factors have been satisfied is a question of fact to be determined on a case by case basis.

The judge was satisfied that the evidence showed that Vinashin was insolvent. In order to adjudicate on whether the elements of (ii) and (iii) above had been satisfied, Justice Blair had to consider the terms and status of the restructuring.

Restructuring negotiations had been ongoing for two and a half years prior to the hearing. Broadly speaking, the restructuring provided for the lenders exchanging their existing claims under the Loans for fixed rate guaranteed notes which would mature due in 2025. The notes were to have the benefit of a Sovereign guarantee provided by the Government of the Republic of Vietnam. Vinashin provided evidence that 57.1% of the lenders (76.83% by value of claims) had executed a restructuring undertaking agreeing to the restructuring. Although such consent was conditional on Vinashin obtaining the Sovereign guarantee, the percentage of lenders that had executed the restructuring undertaking meant that Vinashin had secured the necessary lender support to qualify for a scheme of arrangement. Justice Blair emphasised that it was clear that a vast amount of work had gone into the

restructuring and given that the requisite majority of lenders had agreed and a date was provisionally booked for the first scheme hearing, there was at least a reasonable prospect of the scheme going ahead.

In exercising its discretion to grant a stay, the court had to consider whether the Claimants would suffer any prejudice if the stay on proceedings was granted. Vinashin had no defence to the Claimants debt recovery claims, and as such, the prejudice which the Claimants would suffer if the proceedings were stayed, would be the fact that they would be precluded from taking steps to enforce judgments on claims where there is no defence. However, given that Vinashin was insolvent at the time, the court was required to take into account the interests of creditors as a whole and whether a failure to grant the stay would prejudice the creditors as a whole.

Blair J. preferred Vinashin's submission on this issue, such submission being that the lenders that supported the scheme of arrangement had entered into the restructuring undertakings on the basis that all lenders would be bound by the terms of the scheme of arrangement. In practice, the scheme of arrangement could not proceed where certain members of the lender group would not be bound by its terms. Restructuring negotiations were at a delicate stage and permitting the Claimants to bring their proceedings (to which there was no defence) may cause the scheme of arrangement to fail and result in the other lenders pursuing similar claims against the debtor. Such a scenario could potentially result in a 'free for-all' which, the evidence demonstrated, would result in a less favourable result for the creditors as a whole.

The court did note that it needed to strike a balance and not over extend the stay. As a result, the court granted the stay on proceedings until the first court hearing to sanction the scheme of arrangement had taken place.

Conclusion

This case demonstrates that an English court is willing to exercise its case management powers to stay proceedings brought by dissentient creditors to provide a debtor with the opportunity to implement a scheme of arrangement. A company seeking such a stay must, however, be able to demonstrate that the scheme of arrangement is on foot and that it has a reasonable prospect of success. In this case, the debtor had obtained contractual commitments (in the form of the restructuring undertakings) from the requisite majority of creditors which were required to approve the scheme of arrangement. This, together with the fact that term sheets had been prepared and the first court hearing to sanction the scheme had been scheduled, helped to demonstrate that the scheme of arrangement did have a reasonable prospect of succeeding.

Recent Delaware Bankruptcy Court Decision Limits Secured Claimholder's Right to Credit Bid: The *Fisker* Decision and its Implications

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Following the United States Supreme Court's unanimous decision in *RadLAX Gateway Hotel, LLC v Amalgamated Bank*,[2] upholding the right of a secured claimholder to 'credit bid' its claim at a bankruptcy auction, one could hardly blame the U.S. distressed community if it thought the uncertainty involving credit bidding was largely sidelined. A recent decision from the Bankruptcy Court for the District of Delaware (the 'Court') in the *Fisker* chapter 11 case, however, has renewed the debate.[3] This time, the issue wasn't whether a secured claimholder would be denied the opportunity to credit bid (as it was in *RadLAX*), but rather how much of the claim could be credit bid. By its decision, the Court limited the amount a secured creditor could credit bid to the price it paid for the claim, which was roughly 15% of the principal amount. Not surprisingly, the decision has been highly controversial and oft-criticized. As explained below, however, this reaction may be overblown, as *Fisker* involved a unique set of circumstances that should have limited application in other cases.

Background

Founded in 2007, Fisker Automotive Holdings, Inc. and Fisker Automotive, Inc. (collectively, 'Fisker') designed and manufactured luxury hybrid electric vehicles. In 2010, the United States government, through the Department of Energy ('DOE'), provided a loan to Fisker for the development, production, sale, and marketing of two specific prototype vehicles. Despite having such a high-profile backer, Fisker's business suffered. In addition to losing a material portion of its inventory in Hurricane Sandy, Fisker had to institute safety recalls related to battery packs supplied by a third-party vendor. Eventually, the DOE decided to exit the Fisker loan and, in October 2013, DOE held a public auction at which it sold the loan to Hybrid Tech Holdings, LLC ('Hybrid') for USD 25 million, even though the secured loan had an outstanding principal amount of USD 168.5 million.

With the loss of its funding source, Fisker and Hybrid began discussions over the terms of a sale of Fisker's assets to Hybrid through a credit bid of the newly purchased secured claims. These discussions culminated in an agreement in which Hybrid would credit bid up to USD 75 million of the USD 168.5 million principal amount of the loan in exchange for substantially all of Fisker's assets. Having determined that a sale process was unlikely to elicit higher or better bids than the Hybrid credit bid, Fisker then filed a chapter 11 case in November 2013 for the sole purpose of consummating this private sale to Hybrid. Notably, the private sale to Hybrid was scheduled on an accelerated and truncated timeline, providing only 24 business days for parties to challenge the sale.

Fisker's assumption that no other bidder would emerge proved to be incorrect. Wanxiang American Corporation ('Wanxiang') expressed interest in acquiring Fisker and found a champion in the statutory creditors' committee (the 'Committee'). The Committee opposed the private sale to Hybrid and instead advocated for a sales process that would provide Wanxiang with an opportunity to participate. But there was a catch – Wanxiang made it clear it would only bid if Hybrid's ability to credit bid was curtailed. As a result, the Committee asked the Court to both approve an auction process and limit Hybrid's credit bid. To support this relief, the Committee argued alternatively that: (i) certain of Hybrid's liens were either unperfected or subject to bona fide dispute; (ii) limiting Hybrid's ability to bid would make the sales process more competitive; and (iii) the sale would include both encumbered and unencumbered assets and credit bidding is impermissible for the latter assets.

Notes

1 The views expressed herein are solely those of Ms Zerjal and Mr Abelson, and not necessarily the views of Proskauer Rose LLP or any of its attorneys.

2 132 S. Ct. 2065 (2012).

3 *In re Fisker Automotive Holdings, Inc.*, 2014 WL 210593 (Bankr. D. Del. January 17, 2014).

To limit the scope of the dispute, Fisker and the Committee stipulated to certain facts: (i) if Hybrid's credit bid was limited, there would be a robust auction; (ii) if Hybrid's credit bid was not limited, there would be no auction (i.e., Wanxiang would not participate); (iii) the assets must be sold as a package and not piecemeal; and (iv) the sale includes encumbered assets, unencumbered assets, and assets to which there is a material dispute as to whether a lien has been properly perfected.

As noted, the Court agreed with the Committee and approved an auction process between Wanxiang and Hybrid, and capped Hybrid's credit bid at the USD 25 million purchase price.

Court's decision

Beginning where the United States Supreme Court says courts should always start, the Court first reviewed the language of the relevant statute.[4] Bankruptcy Code section 363(k) provides that, *unless the court for cause orders otherwise*, a secured claimholder that bids at a sale of its collateral may offset its *allowed* claim against the purchase price.[5] The two italicized portions of this language go to the heart of the Court's decision.

As to the first, the Court noted that the Bankruptcy Code expressly reflects that a secured claimholder has a right to credit bid and that such right is not absolute. Quoting from *dicta* in the Third Circuit's decision in *Philadelphia Newspapers*, the Court notes that the 'for cause' exception is not limited to situations where the secured claimholder acts inequitably, but can be employed to advance policy goals under the Bankruptcy Code, including ensuring there will be a successful reorganization or fostering a competitive bidding process. As to the last point, the Court stressed that, due to Wanxiang's refusal to participate in a sale in which Hybrid will be able to credit bid without limit, 'bidding will not only be chilled without the cap; bidding will be frozen'.[6]

In addition, the Court found the truncated timing of the private sale would freeze out other bidders. The Court seemed particularly annoyed by this, noting that neither Fisker nor Hybrid could satisfactorily explain the need for an accelerated process and that Hybrid's supposed drop-dead date for completion of the sale was 'pure fabrication, designed to place maximum pressure on creditors and the Court'.[7] Fisker's failure, the Court wrote, 'has damaged too many people, companies and taxpayers to permit Hybrid to short-circuit the bankruptcy process.'[8]

The Court then addressed the uncertainty surrounding Hybrid's claims. As noted, Fisker and the Committee agreed that Hybrid's claims were partially secured, partially unsecured, and of uncertain status for the remainder. Regardless, Hybrid argued that under Third Circuit precedent[9] it was still entitled to credit bid its entire claim. As the Court noted, however, *Submicron* actually held that a fully perfected, but undersecured, claimholder could nonetheless credit bid its entire claim. Thus, *Submicron* was distinguishable because it addressed an unquestionably allowed claim, while the extent of the allowance of the claim was still an open question in *Fisker*.

Analysis

Since its issuance, *Fisker* has been highly controversial. Much of the controversy has focused on the uncertainty the decision has injected into the secured lender and distressed investor community as to the ability to credit bid the full amount of the claim regardless of the price paid for it. As noted by the Supreme Court in *RadLAX*, credit bidding serves an important purpose by assuring the secured claimholder that the debtor will not just sell its collateral for an under-market price.[10] If the secured claimholder thinks its collateral is worth more than the price the debtor is otherwise obtaining, then it can simply bid its claims and take the collateral for itself. Lenders extending secured credit and distressed investors buying debt on the secondary market rely on that power. The reality is that post-*Fisker*, those parties risk having a bankruptcy court follow *Fisker* and limit their right to credit bid for reasons that cannot be anticipated at the time they extend credit or buy debt (*e.g.*, lack of a robust auction process due to credit-bidding). But that risk was always inherent in section 363(k) and the amorphous phrase 'for cause'.[11]

And that is the real issue with the *Fisker* decision. Rather than providing clarity to market participants, it has muddled the risk profile for secured debt. As noted,

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4 *Ransom v FIA Card Services, N.A.*, 131 S.Ct. 716 (2011) ('Our interpretation of the Bankruptcy Code starts "where all such inquiries must begin: with the language of the statute itself."'), quoting *United States v Ron Pair Enterprises, Inc.*, 109 S.Ct. 1026 (1989).

5 11 U.S.C. §363(k).

6 2014 WL 210593 at *5.

7 *Id.* at *5, fn. 4.

8 *Id.* at *5.

9 *In re Submicron Systems Corp.*, 432 F.3d 448 (3d Cir. 2006).

10 132 S. Ct. at 2070, n.2 ('The ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price. It enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan.')

11 The phrase 'for cause' is not defined in the section 363(k) or elsewhere in the Bankruptcy Code.

the Court found three reasons to limit Hybrid's bid: (i) the lack of an auction process if unlimited credit bidding was allowed; (ii) the inequity of an unnecessarily compressed timeframe for the private sale to Hybrid; and (iii) the uncertain status of Hybrid's claims. The Court does not provide guidance as to whether all three of these factors are needed to establish 'cause', or whether any one of them alone would suffice. Logically, however, it cannot be that mere chilled bidding is enough to justify restricting the ability to credit bid because then the exception would swallow the rule. In nearly all instances in which the secured claims are undersecured, credit bidding will result in bidding being chilled.[12]

Moreover, the unfairness of trying to jam through the private sale on a truncated schedule is fairly minor and ultimately was not an issue because the Court denied the expedited timing (it's not inequitable to ask for expedited relief, unless it is vexatious). The last factor can stand alone, though. Only allowed claims can credit bid, and Hybrid's claims were only partially allowed. Indeed, the Court could have used the proposed timing limitations against Hybrid by finding that the uncertainty surrounding the allowance of its claims and the need for expedition justify depriving Hybrid entirely of its right to credit bid. By doing so, the Court could have avoided the *Fisker* firestorm altogether.

What becomes clear from the above analysis is that the hand-wringing by commentators may be overblown. *Fisker* involved a unique combination of circumstances that is not likely to be replicated. Indeed, the Court believed the situation to be so unique as to designate the decision as 'non-precedential'.[13] That is helpful as far as it goes (courts can still consider it persuasive and adopt its reasoning), but *Fisker* will provide ammunition for opportunistic parties looking to challenge a secured claimholder's right to credit bid.

Aftermath

Knowing that an auction was approaching and that it may be too late once the auction closed, Hybrid asked the U.S. District Court for the District of Delaware for leave to appeal the decision on an emergency basis, which request was denied. A subsequent emergency motion for a direct appeal to the Third Circuit was similarly denied.

Interestingly, the auction proceeded and Wanxiang outbid Hybrid for the assets. The purchase price was reported to be USD 149.2 million, nearly double the amount of the originally offered credit bid.

Fisker does not likely represent a sea change in how courts approach the limits of credit bidding, but that will not be certain until other courts start to address similar challenges.

Notes

12 An exception to this rule is where there is only one bidder for an asset and the secured claimholder is the only party that can provide a market check on a low-ball bid. Indeed, by limiting Hybrid's ability to credit bid to the amount it paid for the claims (USD 25 million), the Court risked having this occur (*i.e.*, if Hybrid decided not to participate, then Wanxiang would have been able to buy the assets for just over USD 25 million). One factor a court should consider, then, is whether the credit bidder is actually needed to keep the auction process honest.

13 Hearing Transcript, 10 January 2014, at 135.

Comity, COMI and Anti-Suit Injunctions: *Kemsley* before the English and US Courts

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I. *Kemsley*: background

The personal bankruptcy of a once prominent English businessman paved the way for two decisions showing the interplay of the English and US courts in considerations of comity, the UNCITRAL Model Law on Cross-Border Insolvency, and the centre of main interests ('COMI').

Paul Zeital Kemsley ('Kemsley') moved to the US with his family in 2009 after the collapse of his business. The family resided in Boca Raton, Beverly Hills, and New York, until Kemsley's wife moved back to the UK with their children in June 2012. Kemsley filed for bankruptcy in London (the 'English Proceeding') under the Insolvency Act 1986 ('IA 1986') on 13 January 2012. Kemsley's bankruptcy petition was based on his physical presence in England at that time, and on having had a place of residence in England within three years of presentation. The High Court of Justice (the 'English Court') declared Kemsley a bankrupt on 26 March 2012, and shortly thereafter, two trustees were appointed in the English Proceeding. Barclays Bank PLC ('Barclays'), a major creditor in the English Proceeding, sued Kemsley on 1 March 2012 in state court in New York and Florida, broadly seeking relief and remedies relating to a breach of a loan agreement to collect on a personal loan of GBP 5 million advanced to Kemsley. In response, Kemsley sought to stop Barclays on two fronts. First, on 21 August 2012, Kemsley's bankruptcy trustee (the 'Foreign Representative') filed a chapter 15 petition with the United States Bankruptcy Court for the Southern District of New York (the 'US Court'), seeking recognition of the English Proceeding as foreign main proceeding, and, in the alternative, as foreign non-main proceeding. The chapter 15 case was filed, in part, to stay Barclays' proceedings against Kemsley in the US. Second, after the filing of the chapter 15 petition but before recognition, Kemsley sought an anti-suit injunction against Barclays in the English Proceeding.

The decisions of the English Court and the US Court were issued on 8 and 11 March and 22 March 2013, respectively.

II. *Kemsley*: the English perspective

The decision of Mr Justice Roth in *Kemsley v Barclays Bank plc* [2013] EWHC 1274 (Ch) is useful from an English perspective in two principal regards: it confirms the general 'comity' or 'deference' principle which now appears to be the primary regulating factor relating to the grant of anti-suit injunctions (at least in relation to insolvency proceedings), and provides (for the first time) consideration of the role and relevance of COMI and the Model Law to the grant of anti-suit relief.

The comity principle

When should an English Court grant an anti-suit injunction so as to restrict a creditor from taking steps in a foreign forum which are inconsistent, or potentially inconsistent, with the English insolvency regime commenced by or against a debtor? The answer, according to Mr Justice Roth, and consistent with prior jurisprudence, is rarely if ever.

Mr Kemsley sought injunctive relief against Barclays on two bases. First, that Barclays, if it continued proceedings in the US, would obtain an advantage over other creditors as compared to the equitable *pari passu* distribution of assets contemplated by the English bankruptcy process. Second, that Barclays (if it obtained a US judgment which would remain enforceable for 20 years) would avoid and undermine the operation of the debtor's discharge from liability, which discharge was said to be a core element of the English bankruptcy regime.

Barclays conceded at the hearing that it would transfer any recoveries to the bankruptcy estate, subject to deduction of costs and expenses, such that the first basis for the application fell away. The second therefore became the principal focus for the application.

It was common ground between the parties that any stay imposed on proceedings commenced against a bankrupt when a bankruptcy petition was pending, or after the opening of bankruptcy proceedings, by virtue of Section 285 of the IA 1986 did not apply to foreign proceedings and enforcement measures. As such, relief could only be justified under the Court's general power

to grant injunctions contained in Section 37 of the Supreme Courts Act 1981.

There is long-standing authority for the proposition that such a power could, in principle, be used to grant an injunction where an estate is being administered in England, or bankruptcy or winding-up proceedings have been commenced in England, and it was necessary to restrain a person from seeking, by foreign proceedings, to obtain the sole benefit of foreign assets falling in the estate. In such a case, the injunction is granted to protect the jurisdiction of the English court.[1] But it must be shown that the bringing or continuation of the foreign proceedings is vexatious or oppressive. The mere fact that England might be the natural forum for such proceedings, or that collective proceedings are underway in England, is not enough.

So what makes a case vexatious or oppressive? In this context, if and to the extent that inconsistency with English proceedings can and will be raised with the foreign court, something more than merely bringing the proceedings in breach of the collective process contemplated by the English process is required. Wrongful conduct will need to be established which requires the Court to intervene[2] and that, in practice, is likely to require some rather extreme or exceptional facts.[3]

The principal consideration in the insolvency context now appears to be the comity principle:[4] if there is a process for consideration in the foreign court of the objections being raised, comity and common sense suggest that it is the foreign judge who is best placed to decide whether the proceedings in his own court should continue.[5] 'Comity requires a policy of non-intervention': *Mitchell v Carter* [1997] 1 BCLC 673.

There is undoubtedly greater support for the grant of an injunction against a creditor who is resident in the English jurisdiction rather than abroad, or who has proved or otherwise participated in the English process (see the *Kemsley* judgment at [26] to [28]). But this may simply be a consequence of a need, in most cases, to establish personal jurisdiction over the creditor in order to satisfy the Court that relief granted will be effective.

What will need to be shown in every case is a good reason why the decision to stop the foreign process should be made in England rather than abroad (see the *Kemsley* judgment at [29]). What will amount to a good or sufficient reason cannot be definitely stated. But we can ascertain from cases where injunctions have been granted or refused what might be a good or sufficient reason. In this regard, the Court of Appeal decision in *Bloom v Harms Offshore GmbH & Co* [2010] Ch 187 is illustrative of the reluctance of the English court to intervene by way of anti-suit injunction to protect insolvency proceedings. In *Bloom*, *ex parte* maritime attachment proceedings were commenced by two German creditors in New York following the commencement of an administration, with the effect that monies paid by the administrators (who were unaware of the attachment) to a post-administration supplier of services were subject to attachment in New York. The Court of Appeal upheld the grant of an injunction, but for very limited reasons. By itself, the commencement of proceedings in New York did not appear to justify the grant of relief. What was objectionable, and moved the application into the realms of vexatious or oppressive behaviour, was the conduct of the creditors. In particular, the creditors commenced the US process without informing the US court that an administration order had been made and provided what was described as 'a very misleading picture' to the US court. The attachment was aimed at interfering with the process of the administration, and did not fasten on any pre-administration property. The creditors only informed the administrators of the attachment once it had succeeded in attaching sufficient funds and, in all the circumstances, were described as having set a trap for the administrators. As such, Stanley Burton LJ concluded at [29] that the case fell into the 'exceptional category' where considerations of comity would be outweighed notwithstanding the fact that the administrators could and had applied in New York to discharge the attachment. Sir John Chadwick agreed on the basis that it was the setting of a trap that obstructed the discharge of functions for which the English court had appointed the administrators that was key.

COMI and the UNCITRAL Model Law

Both England (as part of Great Britain) and the US have implemented the substance (with local variations) of the UNICTRAL Model Law on Cross-Border Insolvency via, respectively, the Cross-Border Insolvency Regulations 2006 and Chapter 15 of the US Bankruptcy Code. The existence of these provisions, and the reciprocal recognition of insolvency proceedings, was considered by Roth J to provide 'an important consideration for the

Notes

1 *Society Nationale Industrielle Aerospatiale v Lee Kui Jak* [1987] AC 871 at 892E.
2 *Turner v Grovit* [20002] 1 WLR 107 at [24]; *British Airways Board v Laker Airways Ltd* [1985] AC 58 at 95.
3 *Midland Bank plc v Laker* [1986] QB 689 at 700.
4 There are echoes here of the stronger concept of comity advocated by the Supreme Court of Canada in its decision in *Amchem v Workers Compensation Board* (1993) 102 DLR (4th) 96, and perhaps now embodied in Rix LJ's description of the general relevance of comity to the grant of general anti-suit injunctions as set out in *Star Reefers Pool Inc v JFC Group Co Ltd* [2012] EWCA Civ 14. Comity increasingly regulates the court's discretion to grant anti-suit injunction relief for fear of acusations of unnecessary '*egoistic paternalism*'.
5 *Barclays Bank plc v Homan* [1993] BCLC 680 at 687.

present application' (see [39]) and is likely to do so in many future cases.

The English court approached matters on the basis that, in circumstances where Kemsley's COMI was either in England or the US (a question which would be considered by the US Court as part of the extant Chapter 15 recognition application), the need for an anti-suit injunction would only arise in circumstances where Kemsley's COMI was found to be in the US (see [40]). That was because, if his COMI was located in England, the bankruptcy proceedings would be regarded as main proceedings and lead to an automatic stay of proceedings in the US upon recognition.

If COMI was located in the US, and the English bankruptcy was recognised as foreign non-main proceedings, then it would be open for the Trustees to apply to the US Court for a stay in support of those proceedings. But if that application was refused, would there be any scope for an anti-suit injunction?

On the facts of the case before him,[6] and in light of the availability of Chapter 15 relief, Roth J concluded that there was not. At [45], he noted that, even if Kemsley's COMI was located in the USA, 'I do not see how it can be regarded as oppressive or unfair or in any way improper for the question whether Barclays should be allowed to maintain its action in the NY Court on an English debt or whether those proceedings should be stayed or dismissed on the basis that Mr Kemsley had become discharged from his debts under the British statute, or indeed whether there should be any restriction on enforcement on post-discharge assets, to be determined by the NY Court. It is not for the English Court to intervene by preventing Barclays from pursuing its case there.' The conduct of Barclays could not be described as 'underhand' as in the case of Bloom (see [47]).

Roth J noted that it was perfectly proper for different bankruptcy regimes to approach the question of release of bankruptcy debts differently, and that the Model Law was focused on procedure not substance ([48]). It could not be suggested, particularly if COMI was located in the US, that a refusal to apply the approach of the English statute would be contrary to English public policy or some international law principle

Roth J elected not to comment more widely on the relevance of the US having adopted the Model Law to the question of the availability of anti-suit injunctive relief generally to protect insolvency proceedings (for example, where COMI was located in a third jurisdiction: see [49]). It is, however, at least arguable that legislative intervention both in England and abroad aimed at implementing the Model Law renders reliance on the anti-suit jurisdiction even more inappropriate in the vast majority of cases. If the foreign jurisdiction has set out a process for recognition of foreign insolvency proceedings, which parallels that implemented in England, such a process should be the primary method of regulating litigation commenced before the foreign court. If the officeholder cannot obtain recognition and a stay before the foreign court under legislation which implements the Model Law, which is patently a question for the foreign court, it is increasingly difficult (absent extreme urgency) to envisage circumstances in which the comity principle ought ever to be outweighed by the wrongful conduct of a creditor in a particular case.

A US view on anti-suit injunctions

In contrast with the UK approach, the automatic stay imposed in plenary proceedings under the US Bankruptcy Code is expressed as having extraterritorial reach. The bankruptcy estate created under the US Bankruptcy Code includes all of the legal and equitable interests of the debtor, wherever located, held as of the filing date. The automatic stay protects the debtor's property by staying any action aimed at obtaining the property of the estate, and US bankruptcy courts have

Notes

6 Roth J, in a postscript to his judgment, highlighted the following aspects of Judge Peck's subsequent decision in the US Court, which perhaps further explain his reluctance to grant relief:

> '52 It is perhaps material to the position of Barclays in seeking to pursue the NY Proceedings that Judge Peck noted in his judgment:
>
> "… Mr. Kemsley is a bankrupt who does not live like one. Since leaving his debts behind and coming to the United States, his financial difficulties have not diminished his high standard of living. He earns personal income from certain business activities (he has worked for Planet Hollywood and currently represents the iconic Brazilian soccer star Pele through a marketing business with offices in New York known as Legends 10) and rather conveniently also has ready access to abundant free cash (principally in the form of loans or gifts from generous friends) enabling him to live very well."
>
> 53 Further, although he made clear that there was no suggestion that Mr Fry was not acting in good faith, Judge Peck observed:
>
> "…it should be noted that [Mr Kemsley], with the aid of surrogates, has been providing indirect financial support to Mr. Fry to cover the trustee's legal expenses in pursuing recognition under chapter 15.… This financial support may indicate that the trustee's petition for recognition is an aspect of a coordinated trans-Atlantic litigation strategy orchestrated by Mr. Kemsley and his advisers to shield [Mr Kemsley's] assets from enforcement actions by Barclays (notably his Florida real estate)…"
>
> And noting that the granting of the Trustee's application for recognition would benefit Mr Kemsley by stopping the NY Proceedings brought by Barclays, he added:
>
> "The working arrangement between the trustee and Mr Kemsley is an unlikely one. These are parties who would ordinarily be opposed to each other with respect to claims to recover [Mr Kemsley's] assets located in the United States for the benefit of UK based creditors. [Mr Kemsley] and the trustee have formed what amounts to a joint venture – with funding from sources loyal to [Mr Kemsley] – to achieve a result that is adverse to the interests of one of its major creditors."'

in rem jurisdiction extraterritorially – but only by way of *in personam* jurisdiction over entities violating the automatic stay.

Generally, US courts agree that they have ample authority and jurisdiction to issue an anti-suit injunction against parties pursuing litigation in a separate forum, but disagree on the circumstances under which such injunctions are appropriate. Under the 'conservative approach',[7] the court will issue an anti-suit injunction if it is demonstrated that '(1) an action in a foreign jurisdiction would prevent United States jurisdiction or threaten a vital United States policy, and (2) the domestic interests outweigh concerns of international comity'.[8] While comity appears to be at the centre of the conservative approach, the minority 'liberal approach'[9] seems to place a more modest emphasis on comity. Under the latter approach, an injunction is based on equitable factors, such as vexatiousness and oppressiveness of the foreign proceeding. None of the factors are mandatory, but the injunction should not threaten international relations.[10]

The US bankruptcy courts' power to issue an injunction with extraterritorial effect is based on the US Bankruptcy Code, which provides that a court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the US Bankruptcy Code.[11] At least one court held that based on this independent authority, the anti-suit injunction threshold required under the conservative approach (as applicable in that matter) was irrelevant due to the exclusive jurisdiction of the US bankruptcy courts.[12]

Notably, chapter 15 is different than plenary cases under the US Bankruptcy Code in that the proceeding is ancillary in nature, the definition of 'debtor' is limited and specialised, and recognition does not create an estate under the Bankruptcy Code. Accordingly, and in view of international aspects of Chapter 15, the automatic stay does not afford broad anti-suit injunctive relief to a Chapter 15 debtor and applies outside the US only to the extent that such actions affect property of the debtor that is within the territorial jurisdiction of the US.[13]

III. *Kemsley*: the US proceedings

In *Kemsley*,[14] the United States Bankruptcy Court for the Southern District of New York ruled on its first contested petition for recognition of a foreign proceeding for an individual debtor. While recognising that the many personal moves of the individual in the past years made the decision a difficult one, the US Court concluded the English Proceeding could not be recognised as either main or non-main because the UK was neither the debtor's COMI nor a place of establishment, and, accordingly, the requirements for recognition were not met. Notably, as discussed below, the decision adopted an approach to the timing of determination of COMI that was rejected by a higher court shortly thereafter, but the decision is nevertheless relevant for its discussion of an individual's COMI.

In *Kemsley*, the Foreign Representative sought an order recognising the English Proceeding as foreign main or non-main proceeding,[15] based on the premise that Kemsley's COMI or at least establishment was in the UK because (i) he never intended to live indefinitely in the USA and, thus, his COMI did not move with him when he became a resident of the USA; and (ii) his COMI remained in the UK where the English Proceeding was administered, where his children were, and where he had ongoing personal and business interest. Among other things, the Foreign Representative claimed that the ability to use a spare office in London during business trips and his secondary employment with a UK company should prove an establishment, and, accordingly, allow recognition of the English Proceeding at least as foreign non-main proceeding. Barclays objected to the recognition, stating that Kemsley did not meet the statutory requirements for recognition because his residence was in the US, where he had continuously resided for three and a half years, and the UK was neither his COMI nor establishment.

The circumstances of the chapter 15 filing presented a rather unusual set of facts. In contrast with many other chapter 15 cases, in which the foreign debtors sought protection against creditors to prevent them from obtaining an unfair privilege and bypass the foreign insolvency proceeding and its creditors

Notes

7 This approach is followed by the First, Second, Third, Sixth, Eighth, and D.C. Circuits.

8 *See Goss Int'l Corp. v Man Roland Druckmaschinen Aktiengesellschaft*, 491 F.3d 355, 359 (8th Cir. 2007); *see* also *Quaak v Klynveld Peat Marwick Goerdeler Bedrijfsrevisoren*, 361 F.3d 11, 17 (1st Cir. 2004); *Gen. Elec. Co. v Deutz AG*, 270 F.3d 144, 161 (3d Cir. 2001); *Gau Shan Co. v Bankers Trust Co.*, 956 F.2d 1349, 1355 (6th Cir. 1992); *China Trade & Dev. Corp. v M.V. Choong Yong*, 837 F.2d 33, 35-37 (2d Cir. 1987).

9 This approach is followed by the Fifth, Seventh, and Ninth Circuits.

10 *See Kaepa, Inc. v Achilles Corp.*, 76 F.3d 624 (5th Cir. 1996).

11 11 U.S.C. § 105(a).

12 *Sec. Investor Prot. Corp. v Bernard L. Madoff Inv. Sec., LLC*, 474 B.R. 76, 86 (S.D.N.Y. 2012) (internal citations omitted).

13 *In re JSC BTA Bank*, 434 B.R. 334, 337 (Bankr. S.D.N.Y. 2010).

14 *In re Kemsley*, 489 B.R. 346 (Bankr. S.D.N.Y. 2013).

15 The key difference among the two is that in a foreign main proceeding, certain relief (including the automatic stay) is granted automatically. Relief that is available automatically upon recognition of a main proceeding under Bankruptcy Code section 1520 may be granted at the discretion of the court in a nonmain proceeding if the requirements of Bankruptcy Code sections 1521 or 1507, as applicable, are satisfied.

by seizing the debtors' assets in the US, Barclays was willing to cooperate with the UK trustees for the benefit of all creditors with valid claims in the UK and to ratably share any net recoveries realised in Barclays' lawsuits against Kemsley in the US. The motivation for Barclays' actions can be seen from the passage of the judgment cited at footnote 5 above. Nevertheless, the Foreign Representative failed to reach an agreement with Barclays and, instead, formed an unusual coalition with the debtor – Kemsley, who was also providing indirect financial support to the Foreign Representative to cover his expenses related to the chapter 15 petition. The US Court noted that these facts may indicate that the chapter 15 petition was 'an aspect of a coordinated trans-Atlantic strategy orchestrated by Mr. Kemsley and his advisers to shield [his] assets from enforcement actions by Barclays'.[16] Even though such enforcement actions could have benefitted all creditors in the English Proceeding (based on Barclays' assurances) and the Foreign Representative's actions raised potential conflict issues, these facts were ultimately not directly related to whether the English Proceeding could be recognised under chapter 15 – or, in other words, where Kemsley's COMI or establishment was located.

In the case of an individual, the habitual residence is presumed to be the debtor's COMI in the absence of evidence to the contrary.[17] Habitual residence is not defined, but has been interpreted as the place where an individual resides with the intention of remaining for an indefinite period of time.[18] Judge Peck noted that 'habitual residence includes an element of permanence and stability and is comparable to domicile; it connotes a meaningful connection to a jurisdiction, a home base where an individual lives, raises a family, works and has ties to the community'.[19]

Kemsley's moves from the UK to the US and then within the US required an analysis of not only the place where an individual lives, but the ongoing personal intentions to stay in a certain location for the foreseeable future until a significant change occurs – including one involving the person's family members.[20] Struggling with Kemsley's 'unsettled'[21] life, the US Court found two possible conclusions: (i) Kemsley may have lived in the US without the intention of establishing a habitual residence; and (ii) any of Kemsley's residences in the US became habitual the moment he decided to stay there indefinitely. Any determination based on these premises would be highly subjective, but the US Court relied on a constant theme in Kemsley's testimony: the central role of Kemsley's children and his interest to reside with them. Accordingly, the US Court recognised Kemsley's COMI shifted when he sold his house in the UK and moved to the US with his family in 2009. Next, the US Court found Kemsley's children move to the UK to be a significant change that affected any commitment Kemsley may have had to remaining in the US indefinitely.

Having established two significant points in time, the US Court considered the relevant time to determine a foreign debtor's COMI and sided with a line of cases ruling that the date of commencement of a foreign proceeding is the proper date to determine the foreign debtor's COMI. Kemsley's English Proceeding commenced in 2012, when Kemsley had been residing in the US with his children for over two years. Therefore, the US Court found that Kemsley's COMI at the relevant time was in the US, and not in the UK, and the English Proceeding did not meet requirements for recognition as foreign main proceeding.

The requirements for foreign non-main proceeding were also not met. The US Court found the evidence supporting Kemsley's establishment in the UK inconclusive and insufficient. Specifically, his secondary employment with a UK company, owned and operated by Kemsley's close friend, was based solely on an 'informal arrangement between friends',[22] and any money received was rather an advance than compensation for actual work. In addition, the office space Kemsley purportedly had available during his trips to London was not assigned to him based on a regular schedule, and the US Court found that insufficient to establish that he used it to carry out non-transitory economic activity.[23]

It is notable that *Kemsley* was decided before the ruling, on 16 April 2013, of the United States Court of Appeals for the Second Circuit (its decisions are binding for the US Court) in *Fairfield Sentry*. That ruling resolved a split among decisions and concluded that, for the purposes of recognition under chapter 15, the time of filing of the chapter 15 petition is the relevant time for COMI consideration.[24] Judge Peck had noted

Notes

16 *In re Kemsley*, 489 B.R. at 351-352.
17 11 U.S.C. § 1516(c).
18 *In re Ran*, 607 F.3d 1017, 1022 (5th Cir. 2010).
19 *In re Kemsley*, 489 B.R. at 353.
20 *Id.* at 353.
21 *Id.* at 355.
22 *Id.* at 363.
23 A 'foreign nonmain proceeding' is a foreign proceeding, other than a foreign main proceeding, pending in the country where the debtor has an establishment, which is any place of operations where the debtor carries out a nontransitory economic activity. *See* 11 U.S.C. §§ 1502(2), 1502(5), 1517(b)(2).
24 *Morning Mist Holdings Ltd. v Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127 (3d Cir. 2013).

in *Kemsley* that the approach adopted and result might have been different if COMI were tested as of the filing date of the Chapter 15 petition, when Kemsley was living in New York, separated from his children, and testified that he wanted to relocate to London to be closer to his children.

An English view on the recognition proceedings

Testing COMI (as Judge Peck did) as the time of the opening of the foreign proceedings is a familiar approach to English advisors: in England, both for the purpose of the provisions implementing the Model Law, and the EC Regulation on Insolvency Proceedings, the Courts have concluded (or proceeded on the basis) that COMI is tested at the time that the foreign proceedings are 'opened': see *Re Stamford* [2011] Ch 33 at [30]. This is the case, even though it has been noted that the purpose of the two sets of regulations differ (the former dealing with procedural rules of recognition, the latter substantive rules of jurisdiction) such that the approach to timing could differ.[25]

The decision in *Fairfield Sentry* has generally been welcomed in the common law world of off-shore insolvency as providing a sensible method for obtaining US recognition of insolvency proceedings commenced in the place of incorporation even if, prior to the liquidation, the place of incorporation could not be regarded as the location of the entities COMI. But the application of the *Fairfield Sentry* approach to timing (i.e. assessing COMI at the point when the chapter 15 application is made) is likely to give rise to further issues in the context of personal insolvency where the debtor will continue to run his post-bankruptcy affairs separate from (and potentially in a different location from) the administration of the bankruptcy estate. For example, if an English bankruptcy is opened when the debtor's COMI is clearly in England, it would be strange if the fact that the bankrupt has then moved to Australia to start a new life would impact on the ability of the trustee to obtain chapter 15 recognition. The simple answer may be that, as in *Fairfield Sentry*, the focus of the analysis will take into account all factors including the COMI of the estate and administration thereof, which may outweigh (in the context of personal insolvency) the post-bankruptcy conduct of the bankrupt.

Notes

25 See Moss, 'The Chapter 15 timing issue – the mist has cleared' (2013) *Insol. Int.* 122.

The Method of Liquidation of a Swap Agreement is Enforceable in Bankruptcy

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In *Michigan State Housing Development Authority v Lehman Brothers Derivative Products, Inc. et al.*, 502 B.R. 383 (Bankr. S.D.N.Y. 2013), the Bankruptcy Court for the Southern District of New York[2] held that contractually prescribed procedures for liquidating a swap agreement, and not just the termination thereof, fall within the U.S. Bankruptcy Code safe harbour protections.

1. Swap agreements in the United States

Swap agreements are contracts to exchange (swap) cash flows at certain predetermined intervals, calculated by reference to an index, including interest rates, currency rates and security or commodity prices.[3] As such, swaps are normally tied to an underlying loan, but they are legally independent obligations. The simplest subgroup are interest rate swaps, in which parties exchange payments tied to a certain interest rate to hedge against the risk of changes in interest rates.[4] For example, a party with a floating rate loan may prefer a fixed rate loan, and can enter into a floating-to-fixed interest rate swap agreement to ensure a fixed net financing cost.[5]

Swaps are customized contracts and are traded over-the-counter (OTC). As of February 2014, the size of the U.S. swap market was estimated at USD 395 trillion.[6] In light of their importance to the overall financial market, qualifying swap agreements (and certain other derivative instruments) enjoy special treatment under the provisions of the Bankruptcy Code, commonly referred to as safe harbour provisions. These rules favour non-debtor counterparties and help to prevent market disruption in three main ways: they (i) allow non-debtor counterparties to enforce contractual rights without having to seek a bankruptcy court order to lift the automatic stay; (ii) exempt counterparties from avoidance powers of a trustee, who may recover certain pre-petition payments made by the debtor (preferences and constructive fraudulent transfers); (iii) permit setoff and netting; and (iv) allow counterparties to enforce termination rights[7] in the event of bankruptcy, which are otherwise unenforceable *ipso facto* clauses.[8]

Generally, section 365(e)(1) of the Bankruptcy Code renders unenforceable provisions that seek to terminate or modify a contractual term when a party files for bankruptcy (*ipso facto* clauses).[9] However, *ipso facto* clauses in swap agreements are enforceable pursuant to the safe harbour of section 560 of the Bankruptcy Code, which provides, in pertinent part:

> 'The exercise of any *contractual right* of any swap participant or financial participant *to cause the liquidation, termination, or acceleration of one or more swap agreements* because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements

Notes

1 The views expressed herein are solely the views of Mr Raicht and Ms Zerjal, and not necessarily the views of Proskauer Rose LLP.
2 Hereinafter referred to as 'Bankruptcy Court'.
3 *Michigan State Housing,* 502 B.R. at 392, citing *Thrifty Oil Co. v Bank of Am. Nat'l Trust & Sav. Ass'n,* 322 F.3d 1039, 1042 (9th Cir. 2003). The Bankruptcy Code definition of a swap agreement in section 101(53B) is a list of types of swap agreements rather than a functional definition.
4 Thomas J. Maloney, 'Still Floating: Security-Based Swap Agreements After Dodd-Frank' (2012) 42:3 *Seton Hall Law Review* 954.
5 *Id.*
6 *See* Weekly Swaps Report at the official website of the U.S. Commodity Futures Trading Commission, available at <www.cftc.gov/MarketReports/SwapsReports/NotionalOutstanding/index.htm>.
7 While termination rights are exempted, the automatic stay applies to any other actions related to the swap agreement (i.e., the debtor cannot be compelled to make payments).
8 *See* 11 U.S.C. §§ 560, 546(g), 362(b)(17) & 561; *see also* Steven L. Schwarcz & Ori Sharon, 'The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis' (2014) 71:3 *Washington and Lee Law Review*.
9 A typical *ipso facto* clause reads: 'This Agreement shall terminate, without notice, (i) upon the institution by or against either party of insolvency, receivership or bankruptcy proceedings or any other proceedings for the settlement of either party's debts, (ii) upon either party making an assignment for the benefit of creditors, or (iii) upon either party's dissolution or ceasing to do business.'

shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.' 11 U.S.C. § 560 (emphasis supplied).[10]

The exception to the general rule disallowing *ipso facto* clauses addresses the importance of an uninterrupted financial market. The absence of such exception could tangle the market and cause significant losses to a counterparty that is unable to resolve transactions with a debtor counterparty.[11] Thus, a bankruptcy filing and the automatic stay do not interrupt the market or the non-debtor counterparty's right to liquidate, terminate or accelerate a swap agreement. The question remains, however, what actions are included (and protected) within the concepts of 'liquidation, termination, or acceleration', and, thus, fall within the safe harbour.

2. The Michigan State Housing decision

a. The swap agreement

The Lehman empire engaged in a myriad of financial transactions, including swap agreements. Pursuant to an ISDA master agreement ('Master Agreement') and accompanying schedule ('Schedule'), Michigan State Housing Development Authority ('MSHDA') and Lehman Brothers Derivative Products Inc. ('LBDP'), a subsidiary of Lehman Brothers Holdings Inc. ('LBHI'), entered into twenty interest-rate swap transactions.[12] The Master Agreement provided for certain 'Events of Default and Termination Events'. Upon the occurrence of an Event of Default, the non-defaulting party had the right to designate an early termination date for outstanding transactions.[13] The Master Agreement and Schedule designated the 'Market Quotation' and the 'Second Method'[14] to calculate amounts owed at the time of termination, but certain other termination events ('Trigger Events'), including the bankruptcy of LBHI (LBDP's parent), dictated a different methodology to calculate amounts owed: the 'Mid-Market' method.[15]

b. The amended swap agreement

On 15 September 2008, LBHI filed for chapter 11, which constituted a Trigger Event under the Schedule.[16] However, instead of immediately terminating the swap agreements, MSHDA and LBDP entered into an assignment and amendment agreement ('Assignment Agreement'), pursuant to which all of LBDP's outstanding obligations under the Master Agreement and Schedule were assigned to Lehman Brothers Special Financing Inc. ('LBSF'), who was not a debtor in chapter 11 at that time. The Assignment Agreement amended the method of calculation for amounts owed at the time of termination. Paragraph 2 of the Assignment Agreement (the 'Liquidation Clause') provided that the parties were to use a 'Mid-Market' method, but in the event of bankruptcy or non-payment of LBSF, the 'Market Quotation' method was to be used.[17]

c. LBSF files for bankruptcy and triggers termination rights – but what is the correct liquidation methodology?

On 3 October 2008, LBSF commenced its own chapter 11 case. MSHDA sent LBSF a letter declaring an event of default and calculated that the amount it owed to LBSF was USD 36,346,426 pursuant to the 'Market Quotation' method. Conversely, LBSF claimed the amount should have been calculated under the 'Mid-Market' method. If the 'Mid-Market' method is appropriate, the amount due to LBSF would be USD 59,401,019 – a USD 23 million windfall.[18] The following diagram explains the dispute.

The parties engaged in a lengthy dispute. LBSF claimed the Liquidation Clause under the Assignment

Notes

10 The protections for safe harbour transactions were further broadened and, in some cases, clarified under the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act. Specifically, section 560 was amended to include protection for the contractual right to cause the liquidation and acceleration of one or more swap agreements in addition to the previously protected right to cause the termination of swap agreements.

11 *Michigan State Housing,* 502 B.R. at 392.

12 *Michigan State Housing,* 502 B.R. at 387.

13 *Id.* at 388.

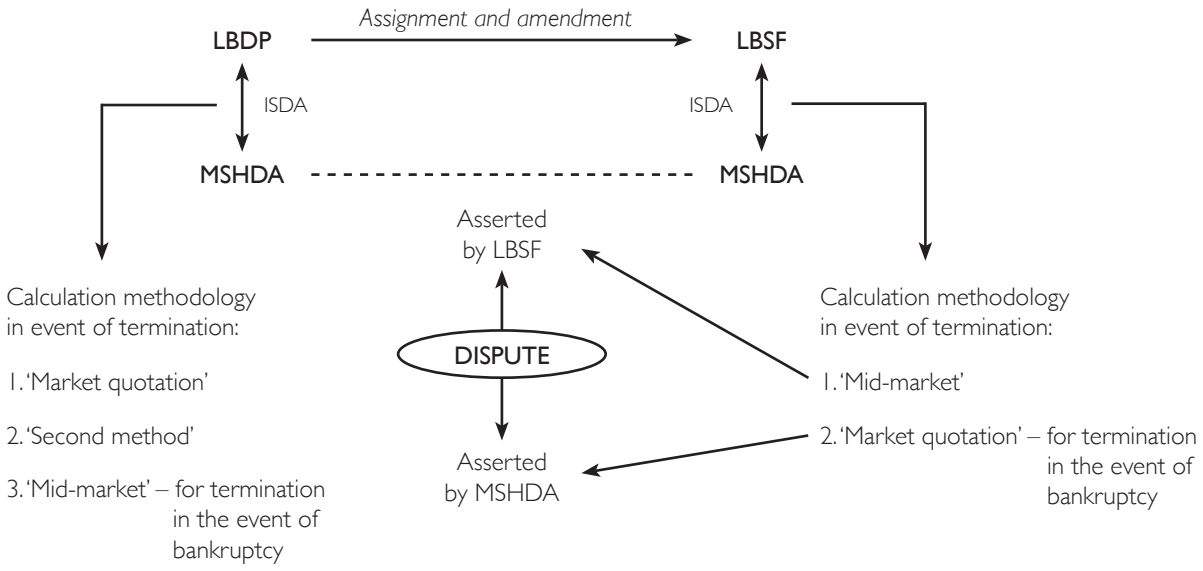
14 'Market Quotation' is based on quotations from 'Reference Market-makers', which are 'four leading dealers in the relevant market selected by the party determining a Market Quotation in good faith (a) from among dealers of the highest credit standing which satisfy all the criteria that such party applies generally at the time in deciding whether to offer or to make an extension of credit and (b) to the extent practicable, from among such dealers having an office in the same city.' *Michigan State Housing,* 502 B.R. at 388 n. 6, citing Master Agreement, § 12. 'Second Method' is the process in which the out-of-the-money party pays the in-the-money party regardless of which party defaults. *Id.*

15 Under the Mid-Market method, the amount due is calculated by using certain 'Market Rates' and 'Volatilities' and by polling a certain 'Dealer Group' as required, to be the mid-market value of the transaction as of the close of business (New York time) on the early termination date. *Michigan State Housing,* 502 B.R. at 388-389, citing Schedule, Part 1(i)(2).

16 *Michigan State Housing,* 502 B.R. at 389.

17 *Id.*

18 *Id.*



Agreement was an impermissible *ipso facto* clause. MSHDA argued that the *ipso facto* clause was protected under Bankruptcy Code section 560 exempting contractual rights to liquidate, terminate, or accelerate a swap agreement, because it deals directly the rights protected under the safe harbour. By contrast, LBSF claimed the liquidation method was merely ancillary to the rights enumerated in the statute and not protected by section 560.[19]

d. The Bankruptcy Court finds the liquidation method falls within the safe harbour

By looking at the plain language of section 560, the Bankruptcy Court analyzed the meaning of the word 'liquidation' and found that it referred to 'the act of determining by agreement the exact amount of something that otherwise would be uncertain'.[20] The Bankruptcy Court held the right to cause the liquidation of a swap agreement *must* be linked to the right to determine the amount due and payable, and such amount can only be determined by using the methodology specified in the swap agreement.[21] Accordingly, the Bankruptcy Court concluded the Liquidation Clause 'naturally fits within the safe harbor' because it constitutes the exercise of MSHDA's right to exercise its contractual right to liquidate, and such rights are protected by the Bankruptcy Code.[22]

The Bankruptcy Court rejected LBSF's contentions that the liquidation methodology was merely ancillary to protected liquidation rights on three grounds. First, the right of liquidation loses all practical meaning if it is not linked to and performed in accordance with some agreed method. Second, LBSF failed to explain why it would be appropriate to use the 'Mid-Market' method, since the benefit to the debtor should not be decisive in considering how to apply the safe harbour. Third, using the contractual method of liquidation promotes stability and certainty – just what the safe harbour is intended to promote.

e. Previous decisions tackling swap agreements are distinguishable

LBSF's argument that the liquidation methodology was merely ancillary to protected rights relied heavily on three previous Bankruptcy Court decisions. In *Lehman Bros. Special Fin. Inc. v. BNY Corporate Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010) and *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. et al. (In re Lehman Bros. Holdings Inc.)*, 452 B.R. 31 (Bankr. S.D.N.Y. 2011), the Bankruptcy Court found that section 560 did not allow non-debtor swap counterparties to improve their position upon bankruptcy and obtain higher distributions. In *BNY Trustee*, the Bankruptcy Court held that a 'flip-clause' that subordinated Lehman's rights to certain collateral upon Lehman's default was an *ipso facto* clause not protected by the safe harbour because, as opposed to the Liquidation Clause, (i) the flip-clause

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19 *Michigan State Housing,* 502 B.R. at 390.
20 *Id.*
21 *Id.*
22 *Id.* at 393.

was included in a separate agreement and not in the swap agreement;[23] and (ii) the flip-clause *did not* deal directly with protected rights to liquidate, terminate, or accelerate. In *Ballyrock*, a contractual provision seeking to lower Lehman's priority of payment was outside the scope of section 560 because it dealt with a substantive provision altering priority and not specifically intertwined with a liquidation, termination or acceleration right. Additionally, in *Calpine Energy Servs., L.P. v. Reliant Energy Elec. Solutions, L.L.C. (In re Calpine Corp.)*, 2009 Bankr. LEXIS 1041 (Bankr. S.D.N.Y. May 7, 2009),[24] the Bankruptcy Court found a provision requiring a defaulting party to provide a written explanation for disputing the non-defaulting party's calculations of the amount owed within two days of receipt was an ancillary provision to the rights protected by the safe harbour. While admitting that words like 'incidental' and 'ancillary' can influence the thin line between acts that are protected by the safe harbour and those that are not, the Bankruptcy Court reiterated that liquidation and liquidation methodology are 'closely connected' concepts that 'become virtually inseparable'.[25]

3. Good news for non-defaulting counterparties?

The Bankruptcy Court's interpretation of section 560 provides, at least, partial certainty. If a swap agreement contains a liquidation methodology applicable in the event of bankruptcy of a counterparty and does not include some other truly ancillary provision, in the Southern District of New York, the party using such methodology to liquidate a swap agreement should fall within the safe harbour. This interpretation of the safe harbour embedded in section 560 is consistent with the intent to prevent market disruption and facilitate swaps and other derivatives transactions.

Notes

23 The rationale of the *Michigan State Housing* decision implies that a liquidation methodology would be enforced even if it was included in a separate agreement.

24 In *Calpine*, the Bankruptcy Court dealt with comparable protections for commodities and forward contracts in Bankruptcy Code section 556.

25 *Id.* at 395.

Crystal Palace FC Limited & another v Kavanagh & others [2013] EWCA Civ 1410: Administrator Wins on Points Difference

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Introduction

The administrator of any insolvent business who needs to make employees redundant will inevitably face the provisions of two, sometimes conflicting, regimes. The Transfer of Undertakings (Protection of Employment) Regulations 2006 (SI 2006/246) ('TUPE') protect employees on the transfer of their employer's business, but is frequently a source of tension with the regime implemented by insolvency legislation where such a transfer takes places in respect of a business in an administration. Whilst TUPE protects the interests of employees, one of the goals of the administration regime is to achieve the best result for the company's creditors as a whole, rather than its employees.

As explained below, Regulation 7 of TUPE addresses this inherent tension, at least to some extent, and it is with this Regulation that the *Crystal Palace* case is concerned. The Court of Appeal in this case, on appeal from a decision of the Employment Appeal Tribunal, provides some useful guidance as to how that provision operates, though it is recognised that their application is highly fact specific. Notwithstanding that the application of Regulation 7 of TUPE is so fact specific though, administrators can certainly take some comfort from the Court of Appeal's decision, which allowed the appeal restoring the decision of the Employment Tribunal.

The Court of Appeal recognised that, although an administrator will often have the ultimate goal of selling the company's business, it does not automatically follow that any dismissals are made with a view to making the business more attractive to a potential purchaser, thus avoiding what seemed to follow from the Employment Appeal Tribunal's decision, that liability for dismissals where a sale of the business is contemplated will almost always pass to the transferee. This matters from an insolvency point of view because, where the transferee assumes liability under TUPE, the purchase price will often be reduced to take that liability into account and that obviously means there is less money available to pay the insolvent company's creditors as a whole.

The Regulations

Regulation 7 of TUPE provides that where either before or after a relevant transfer an employee of the transferor or transferee is dismissed, the employee shall be treated as unfairly dismissed if the sole or principal reason for his dismissal is:

'(a) the transfer itself; or

(b) a reason connected with the transfer that is not an economic, technical or organisational reason entailing changes in the workforce.'

Under Regulation 4 of TUPE where the dismissal of a transferor's employee is treated as unfair pursuant to Regulation 7, liability in respect of the dismissal is transferred to the transferee. That being the case, whether or not the sole or principal reason for the transfer is the transfer itself or a reason connected with the transfer is of huge importance. Similarly, if the sole or principal reason for the transfer is a reason connected with the transfer, it is crucial to determine whether that reason is an economic, technical or organisational reason entailing changes in the workforce ('an ETO reason').

Prior to the *Crystal Palace* case, the question of what amounts to an ETO reason had been the subject of much discussion, and some case law.

The *Spaceright* decision

Spaceright Europe Limited v Baillavoine [2012] ICR 520 concerned the dismissal by administrators of the Chief Executive of a company in administration, on the day the company went into administration. A few weeks later the company's business was sold and, in the context of that sale it fell to be determined whether the reason for the Chief Executive's dismissal was an ETO reason. The Court of Appeal (as well as the Employment Tribunal and the Employment Appeal Tribunal) concluded that, the reason for the Chief Executive's dismissal was connected with the transfer, but it was not an ETO reason.

It is, in particular, worth noting what Mummery LJ (with whom Sir David Keene and Richards LJ agreed) at paragraph 47:

> 'For an ETO reason to be available there must be an intention to change the workforce and to continue to conduct the business, as distinct from the purpose of selling it. It is not available in the case of dismissing an employee to enable the administrators to make the business of the company a more attractive proposition to prospective transferees of a going concern.'

On the facts of that case, the Court of Appeal concluded that the Chief Executive was dismissed because a purchaser of the business would not require such an officer. As such the reason for the dismissal did not relate to the conduct of the business as a going concern and, therefore, it was not an ETO reason.

The facts

What does, or does not, amount to an ETO reason came before the Court of Appeal again in the *Crystal Palace* case, though in quite a different factual context.

The Claimants in the *Crystal Palace* case were employees of an insolvent football club, Crystal Palace Football Club (2000) Limited ('the Company'), which went into administration in January 2010. The administrator's aim was to sell the club as a going concern. Progressing a sale, however, proved difficult because a purchaser, who had been given preferred bidder status, wanted to purchase Selhurst Park stadium, as well as the club, the stadium being owned by another company which was also in administration, although with different administrators having been appointed.

In view of the stalling negotiations, together with the club's cashflow problems, the Company's administrator decided to '*mothball*' the club over a period when no games would be played. As part of that the Claimants were made redundant in May 2010.

Once there had been a sale, the Claimants argued that Regulation 7 of TUPE was engaged and, moreover, that liability for their dismissals passed to the transferee.

It was not in dispute that the principal reason for the transfers was not the transfer itself. Rather, the issue was whether it was a reason connected with the transfer that was not an ETO reason.

ET and EAT decisions

The Employment Tribunal concluded that the reason for the dismissals was connected with the transfer, but that it was an ETO reason and therefore that liability arising out of the dismissals remained with the Company rather than passing to the transferee. The Claimants appealed.

The Employment Appeal Tribunal, on the employees' appeal, held that they had *not* been dismissed for an ETO reason, so that liability in respect of their dismissals had indeed passed to the transferee.

The Employment Appeal Tribunal's reasoning drew on the decision in the *Spaceright* case. As touched on above, in the *Spaceright* case the Court of Appeal concluded that where the reason for a dismissal is to continue to conduct the business that is an ETO reason, but where the dismissal is part and parcel of a process with the purpose of selling the business it cannot be such a reason.

On the facts, the Employment Appeal Tribunal considered, the administrator did not intend to carry on the Company's business so much as to preserve it so that it could be sold. As such, it was held that the reason for the Claimants' dismissals was the sale of the business, rather than continuing to conduct that business. That being the case, the Employment Appeal Tribunal held, applying the guidance given in the *Spaceright* case, there was no ETO reason operating on the facts.

The Court of Appeal

The Court of Appeal allowed the appeal, restoring the Employment Tribunal's decision. Much of the Court of Appeal's reasoning was concerned with the *Spaceright* case and the ways in which the facts of that case differed from those presently before it, the Court of Appeal taking the view that that case could be distinguished.

The facts of this case were very different to the facts of *Spaceright*. Maurice Kay LJ, delivering the leading judgment, distinguished *Spaceright* on the basis that in that case it was always contemplated that the dismissed Chief Executive would be replaced (which indeed he was) and therefore there was no reduction in the workforce, merely a dismissal to make a sale more attractive to a prospective purchaser. Briggs LJ in his supporting judgment added that the application of *Spaceright* should be confined to its factual context.

The nature of the football business, where the main assets are often player contracts, is one in which the liquidation value is normally low. Since one of the objectives of administration is achieving a better result for creditors as a whole than would be likely if the company were wound up, a sale of the business is commonly required in order to achieve the purpose. However, continuation of that company's business is often a prerequisite to a beneficial sale and dismissing employees is a principal method by which an administrator can continue the business. The Court of Appeal found that the Employment Tribunal had correctly separated the administrator's objective in dismissal of the employees in order to continue the business from his ultimate objective of selling the club as a going concern.

Briggs LJ appropriately referred to Regulation 7 as 'the tie breaker' as to how to resolve the conflict between TUPE and the insolvency code. He observed that if the administrator's overall objective to sell the company is

applied as the sole or principal reason for any dismissal, then the ETO exception to Regulation 7(1) will never or hardly ever apply.

Comment

The *Crystal Palace* case is interesting from the point of view of the interaction between the legislation dealing with the position of employees on the transfer of the undertaking of their employer and the regime dealing with companies in financial difficulties in administration. The scope of tension between those regimes is noted above, but it is emphasised that the purchase price, and therefore the return to creditors, is tied up with the question of whether liability passes under TUPE.

The Court of Appeal did rightly recognise that the application of Regulation 7 of TUPE is a fact sensitive issue and, of course, the facts of this case were somewhat unusual in that they related to the business of a football club, which is seasonal.

Nonetheless the case does provide some guidance as to how the Regulation works. The Court of Appeal recognised that an administrator will often have the ultimate aim of selling the business as a going concern, but this does not entail that all decisions will be taken to make the business more attractive to a purchaser. Had the Court of Appeal reached a different conclusion, it would seem to have entailed that nearly any dismissal by an administrator intending a going concern sale would result in liability being passed to the transferee, regardless of whether the dismissals in issue were necessary to keep the business going.

In the circumstances, administrators, and general creditors, can therefore take some comfort from the Court of Appeal's decision in this case, which certainly broadens (or rebroadens) the scope of relying on an ETO reason where an administrator's immediate aim is to continue trading the company's business.

The Section 363 Sale: A Popular Chapter 11 Tool[1]

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Section 363 of title 11 of the United States Code (the 'Bankruptcy Code') authorises a debtor[2] to sell its property in the ordinary course of business without court approval,[3] which facilitates continued and uninterrupted business operations. Conversely, the debtor needs court approval to sell its property outside the ordinary course of business.[4] When such sale of property – commonly known as a 'section 363 sale' – involves the debtor's crown jewel or all of its assets, the sale often becomes a central event that can achieve the goals of a chapter 11 reorganisation without the potentially protracted process of a chapter 11 plan confirmation.

Key features of a section 363 sale

The popularity of section 363 sales can be attributed to the following features.[5]

(i) *Property can be sold 'free and clear' of any interest of another entity in such property*. The sale of property is approved by the bankruptcy court free and clear of interests (even over the objection of a party holding such interest) if one of the following applies: (i) applicable nonbankruptcy law permits the sale of such property free and clear of such interest; (ii) the entity holding the interest consents; (iii) the interest is a lien and the price at which the property is to be sold is greater than the aggregate value of all liens on such property; (iv) the interest is in bona fide dispute; or (v) the entity holding the interest could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.[6]

(ii) *Challenges seeking to set aside the sale are limited*. Bankruptcy Code section 363(m) protects a good faith purchaser and provides that the authorisation or modification on appeal of an order authorising the sale of assets does not invalidate such sale if the purchaser bought such property in good faith (regardless of whether the purchaser was aware of the pendency of the appeal), unless the sale was stayed pending appeal.[7]

(iii) *The sale can be accomplished in a relatively short timeframe*. The most notable flash sale took place in the *Lehman Brothers* chapter 11 case, in which the debtor sold substantial assets only four days after the petition was filed.[8] This factor is particularly relevant when the debtor is running out of cash, when the debtor's ability to restructure successfully is questionable, or when the value of the debtor's assets may deteriorate quickly. In addition, a fast section 363 sale often precludes the need for a protracted confirmation process for a chapter 11 plan, which prevents the accrual of substantial administrative fees.

Notes

1 The views expressed herein are solely those of Ms Zerjal, and not necessarily the views of Proskauer Rose LLP or any of its attorneys.

2 For purposes of this article, the focus is on debtors in chapter 11 of the Bankruptcy Code.

3 11 U.S.C. §363(c).

4 Section 363(b)(1) of the Bankruptcy Code provides, in relevant part, that a debtor 'after notice and a hearing, may sell, or lease, other than in the ordinary course of business, property of the estate'. To determine whether a transaction is in the ordinary course of business or out of the ordinary course, courts generally employ two tests: (i) the 'horizontal dimension test' and (ii) the 'vertical dimension test'. The first test considers whether, from an industry-wide perspective, the transaction is of the sort that companies in that industry undertake commonly. The second test considers whether the transaction subjects a creditor to economic risk of different nature compared to what he accepted when he decided to extend credit. The debtor's prepetition business practices and conduct are key in determining these issues. See, e.g., *In re Sportsman's Warehouse, Inc.*, 457 B.R. 372 (Bankr. D. Del. 2011).

5 See, generally, Robert G. Sable, Michael J. Roeschenthaler & Daniel F. Blanks, 'When the 363 Sale Is the Best Route' (2006) 15 *J. Bankr. L. & Prac.* 2 art. 2, at 123.

6 11 U.S. C. § 363(f).

7 The equitable mootness available under Bankruptcy Code section 363(m) also protects 'transactions integral to a sale'. See, e.g., *Boeing Co. v Kaiser Aircraft Indus. (In re Ala. Aircraft Indus.)*, 464 B.R. 120 (D. Del. 2012) (finding that the establishment of a litigation trust was a 'sale' of property because it was a transaction integral to the sale of assets).

8 See Order Under 11 U.S.C. §§ 105(a), 363, and 365 and Federal Rules of Bankruptcy Procedure 2002, 6004 and 6006 Authorizing and Approving (a) the Sale of Purchased Assets Free and Clear of Liens and Other Interests and (b) Assumption and Assignment of Executory Contracts and Unexpired Leases, *In re Lehman Bros. Holders Inc.*, No. 08-13555 (JMP) (Bankr. S.D.N.Y. Sept. 19, 2008) [Docket No. 258].

(iv) *The sale can bind non-consenting constituencies*. The section 363 sale is binding on non-consenting creditors and other constituencies. In addition, outside of chapter 11, an asset sale may require shareholder approval, which is not required in a section 363 sale.

(v) *The sale can include favourable executory contracts and unexpired leases*. Chapter 11 grants the debtor flexibility by making anti-assignability clauses in executory contracts and unexpired leases unenforceable.[9] Accordingly, the debtor may sell and assign to the purchaser executory contracts and unexpired leases, so long as the purchaser can provide adequate assurance of future performance (*i.e.*, the ability to comply with the contract or lease terms going forward) and all existing defaults under such contract or lease have been cured.

However, an expedited section 363 sale may not be an optimal solution for all debtors. In some cases, parties prefer the greater flexibility of a sale of assets incorporated in a chapter 11 plan, even though confirmation requirements are generally more stringent than the standards to approve a section 363 sale, and waiting for a sale to be incorporated in a plan is not appropriate when assets are quickly losing value. Parties can also choose to pursue a sale outside of chapter 11, which can be done even faster, and is not burdened with the bankruptcy court's oversight, the interference of other parties (e.g., lenders, creditors' committees, etc.), and the negative publicity often surrounding chapter 11 proceedings.

The mechanics of a section 363 sale

The Bankruptcy Code does not require a specific process for section 363 sales, but the Federal Rules of Bankruptcy Procedure simply provide that '[a]ll sales not in the ordinary course of business may be by private sale or by public auction.'[10] However, in sales of a significant asset or all the debtor's assets, an auction is usually the preferred method to ensure the highest price and maximum return to the debtor's estate.

1. The stalking horse

The section 363 sale process often begins with the debtor identifying a 'stalking horse': an initial bidder that negotiates the asset purchase agreement with a floor price for the debtor's assets, subject to 'higher and better' bids and the approval of the bankruptcy court.[11] The stalking horse is either a third party or a secured creditor who intends to invoke its right to credit bid.[12]

In exchange for accepting this lead role and the risk of being overbid, the stalking horse is usually entitled to certain fees, which are negotiated between the debtor and the stalking horse and are included in the asset purchase agreement. These fees generally cover the stalking horse's fees and expenses and a fee compensating the stalking horse if another party prevails in the bidding process. Such fee is commonly in the form of a 'break-up' fee, which is usually approved in the range of 2-4 percent of the proposed price, or a 'topping fee', which is a percentage of the amount by which a prevailing bid by another entity exceeds the stalking horse's offer. Bankruptcy courts are not unanimous in the test used to scrutinise stalking horse fees. Under the 'business judgment' test, courts examine whether there is a reasonable basis for the fee, and whether it was negotiated in good faith and with due care.[13] Under a stricter test, courts consider whether such fee is necessary to preserve the value of the estate and whether it benefitted the estate by inducing or preserving the initial bid.[14]

2. The bidding procedures

The sale procedures are incorporated in a motion seeking the approval of the bidding process. Such motion customarily seeks the entry of two separate orders: a form order approving the bidding procedures, and a form order approving the sale to the winning bidder. This motion typically provides, among other things:

- a description of assets to be sold;
- the stalking horse protections;
- the documents and information required to be submitted to qualify as a qualified bidder;
- the procedures and a deadline to submit bids;
- the auction time and place;

Notes

9 11 U.S.C. §365(f)(1). The exception to this rule are certain personal services contracts. 11 U.S.C. §365(c).
10 Fed. R. Bankr. P. 6004(f)(1).
11 The debtor may choose to auction its assets without a stalking horse, but it risks receiving no bids.
12 Credit bidding is codified in section 363(k), which provides that a secured claimholder that bids at a sale of its collateral may offset its allowed claim against the purchase price, unless the court orders otherwise for cause. In practice, this means that a secured claimholder can serve as a bidder without having to use cash.
13 See, e.g., *In re Integrated Resources Inc.*, 147 B.R. 650 (S.D.N.Y. 1992).
14 See, e.g., *In re Reliant Energy Channelview LP*, 594 F.3d 200, 206 (3d Cir. 2010).

- the required notice of the auction;
- the deadline to object to the sale;
- the procedures for the assumption and assignment of executory contracts and unexpired leases; and
- the date of the hearing to approve the sale.

In addition, bidding procedures often expressly allow the creditors to monitor the process or even be consulted before the selection of the winning bid. The debtor typically reserves the right to modify the bidding procedures to be able to include more bidders (e.g., by extending the deadline to submit bids, modifying the requirement to be a qualified bidder, etc.) to maximise the return to the estate.

In reviewing bidding procedures, courts generally ensure that bidding is encouraged rather than restricted, and that fair disclosure is provided. Accordingly, a bankruptcy court will not approve bidding procedures that may chill bidding.[15] Once the bidding procedures have been approved, qualified bidders submit their bids, which have to prime the stalking horse's offer. Like the stalking horse, qualified bidders often have to provide a deposit and submit evidence of sufficient financing.

3. Auction and court approval of the sale

When there is more than one bidder, an auction is held (often at the debtor's counsel's offices). The auction is attended by the debtor, its professionals, the creditors' committee (and other committees, if appointed) and their professionals, and the qualified bidders, who are given multiple opportunities to increase their bids. At the end of the auction, the debtor selects the 'highest and best' bid, based on its business judgment. The winning bid is often the one offering the highest price, but other factors can prevail.[16]

The last – and most important – step in the section 363 sale process is the approval of the sale. Notably, the delay between the conclusion of the auction and court approval of the sale allows for the possibility of post-auction bids, which sparks a conflict between seeking the 'highest and best' bid and preserving the integrity of the bidding process. Indeed, courts have been prompted to reopen the bidding for various reasons, including when the sale pursuant to the winning bid could not be found to be in the best interest of the estate,[17] when the court was presented with a 'higher and better' bid that could moot procedural objections to the sale process and allow the court to focus on the substance of the bid,[18] or when the court found the purchase price to be grossly inadequate.[19]

The standard courts employ to approve a section 363 sale is business judgment[20] or 'sound business judgment', as adopted by courts in the Third Circuit.[21] Pursuant to the latter, courts consider 'all salient factors pertaining to the proceeding and, accordingly, act to further the interests of the debtor, creditor and equity holder alike'.[22] Relevant factors include:

- the value of the assets in relation to the value of the estate as a whole;
- the time elapsed since the chapter 11 petition was filed;
- the likelihood of a successful reorganisation through the confirmation of a chapter 11 plan;
- the effect of the proposed sale on any future chapter 11 plan, especially with respect to the comparison of sale proceeds and other appraisal of the debtor's estate;
- which of the alternatives of use, sale or lease the proposal envisions, and
- whether the asset is increasing or decreasing in value.[23]

Courts will also consider if the sale was conducted with sound business reasons, accurate and reasonable notice, fair and reasonable price, and good faith.[24]

Notes

15 See, e.g., *In re President Casinos, Inc.,* 314 B.R. 784 (Bankr. E.D. Mo. 2004).

16 When determining which bid is 'higher and better', courts generally defer to the debtor's business judgment. See, e.g., *In re Gulf States Steel of Ala.*, 285 B.R. 497, 517 (Bankr. N.D. Ala. 2002) (upholding bid with higher monetary amount even though lower bid might have created more jobs in community and local government preferred lower bidder because trustee believed higher bid would be of greater benefit to estate, and court gave trustee 'great judicial deference' in deciding which bid to accept); *In re Bakalis*, 220 B.R. 525, 530, 532 (Bankr. E.D.N.Y. 1998) (explaining trustee's recommendation for accepting bid at 363 sale is subject to business judgment rule and upholding trustee's decision to accept monetary bid with second highest monetary value because trustee had concerns that highest bidder could not close); G-*K Dev. Co. v Broadmoor Pl. Inv., L.P. (In re Broadmoor Pl. Inv., L.P.)*, 994 F.2d 744, 745-46 (10th Cir. 1991) (upholding bankruptcy approval of lower bid that bankruptcy court viewed as having 'fewer contingencies and facilitated a more immediate closing').

17 *In re Sunland, Inc.*, Case No. 13-13301 (Bankr. N.M. Mar. 25, 2014).

18 *Allied Systems Holdings, Inc*., Case No. 12-11564 (Bankr. D. Del. Sept. 9, 2013).

19 *In re Western Biomass Energy LLC*, Case No. 12-21085 (Bankr. D. Wyo. Aug. 6, 2013).

20 See, e.g. *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983).

21 See, e.g., *In re Abbots Dairies of Pa., Inc.*, 788 F.2d 143 (3d Cir. 1986).

22 *Travelers Cas. & Sur. Co. v Future Claimants Representative,* 2008 U.S. Dist. LEXIS 23496, *11 (D.N.J. Mar. 25, 2008) (internal citations omitted).

23 *In re Lionel Corp.*, 722 F.2d at 1071.

24 *In re Titusville Country Club*, 128 B.R. 396 (W.D. Pa. 1991).

However, these factors are non-dispositive, as bankruptcy courts have substantial discretion in deciding whether to approve a section 363 sale.[25]

The sale order is a critical document the purchaser relies on to protect itself from any encumbrances and claims against the purchased assets. As discussed below, in spite of its 'free and clear' nature, the section 363 sale may not completely absolve the purchaser of liabilities (especially those arising from post-closing events), but the careful wording of the sale order is essential to afford the purchaser maximum protections.

Generally, any order approving the sale of property of the bankruptcy estate does not become effective until 14 days after such order is entered to provide parties an opportunity to file an appeal or make a motion for reconsideration before the sale is final.[26] However, to avoid additional delay, debtors routinely request that this stay requirement be waived so that the closing may occur immediately after the sale is approved by the bankruptcy court. As discussed above, Bankruptcy Code section 363(m) limits the ability to challenge a section 363 sale to a good faith purchaser[27] so long as no stay of the sale is in effect, which serves to encourage the purchase of assets through a section 363 sale and maximise the price by reducing the risk of the sale being set aside.

The Bankruptcy Code does provide an exception to the finality of a section 363 sale in the event of collusion. Bankruptcy Code section 363(n) provides that the debtor may avoid a sale if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which the sale was consummated.[28]

Obstacles to consider

1. Successor liability may haunt the purchaser

Bankruptcy Code section 363(f) enables the debtor to sell property 'free and clear of any interest in such property'. While the scope of the 'free and clear' language is broad, the phrase 'interest in such property' is not defined in the Bankruptcy Code, and can exclude successor liability claims. For example, in *Grumman Olson*, a tort claimant sued the purchaser of assets in a section 363 sale for personal injuries suffered when driving a defective FedEx truck that was manufactured and sold by the debtor prior to bankruptcy and the section 363 sale. Even though the sale order exonerated the buyer from claims against the debtor based on successor liability, the court found that because the tort claim did not arise until after the bankruptcy, and the plaintiffs did not have notice of the bankruptcy proceedings, the purchaser of assets could not be shielded from liability.[29] Conversely, in *Chrysler*, the same court found that plaintiffs, who sued New Chrysler based on a design flaw on their vehicles, had a prepetition relationship with the debtor,[30] and had adequate notice of Chrysler's well-publicised bankruptcy case and the design defect, since the debtor had issued at least two recall notices regarding this very design defect before its bankruptcy.[31] Accordingly, the order approving the section 363 sale of Chrysler's assets to New Chrysler barred the plaintiff's claims.

In light of these and other precedents, purchasers of assets that could give rise to future claims must consider these potential liabilities when determining a fair price for the assets, and should include appropriate language regarding successor liability in the sale order to reduce risk (e.g., language specifically absolving the purchaser of successor liability, enjoining any holder of a successor liability claims to pursue any actions against the purchaser, specifically identifying the liabilities assumed by the purchaser, etc.).

2. Section 363 sales may not be a sub rosa *plan*

A section 363 sale constitutes a *sub rosa* plan if such sale pre-empts or dictates the terms of a chapter 11 plan. This concept was first discussed in *In re Braniff Airways, Inc.*,[32] in which the court held that '[t]he debtor and the bankruptcy court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganisation plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets'.[33] In that decision, the court found that the terms of the proposed sale had the effect of (i) dictating

Notes

25 *Travelers Cas. & Sur. Co. v Future Claimants Representative,* 2008 U.S. Dist. LEXIS 23496 at *11.
26 See Rules 6004(h) and 6006(d) of the Federal Rules of Bankruptcy Procedure.
27 A finding related to the 'good faith purchaser' should be included in the sale order.
28 11 U.S. C. § 363(n). The debtor may also recover costs and expenses incurred in avoiding such sale or recovering such amount, and punitive damages may also be granted.
29 See, e.g., *Morgan Olson, LLC v Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243 (Bankr. S.D.N.Y. 2011), *aff'd*, 467 B.R. 694 (S.D.N.Y. 2012).
30 By contrast, the plaintiff in *Grumman Olson* was not the owner of the truck, and at the time of the section 363 sale, it was not predictable that the plaintiff could be injured with the assets that were subject to the section 363 sale.
31 *Burton v Chrysler Group, LLC (In re Old Carco LLC)*, 492 B.R. 392, 402-403 (Bankr. S.D.N.Y. 2013).
32 *In re Braniff Airways, Inc*, 700 F.2d 935 (5th Cir. 1983).
33 *Id.* at 940.

any future reorganisation plan, (ii) disenfranchising creditors from their right to vote on a reorganisation plan, and (iii) releasing the claims of all parties against the debtor.[34]

While the *sub rosa* argument is often used in objections, it is rarely a winner.[35] The issue was litigated in the *Chrysler* and *General Motors* cases, in which substantially all the companies' assets were respectively sold to 'New Chrysler' and 'New General Motors'. In both cases, the Bankruptcy Court for the Southern District of New York held that the section 363 sales were not *sub rosa* plans. In *Chrysler*, the court supported its decision by finding, among other things, that: (i) first priority lenders were receiving the full value of their collateral with sale proceeds, and such value was higher than what they would have received in liquidation; and (ii) the assumption and assignment of contracts was an option available under the Bankruptcy Code and not an indication of a *sub rosa* plan.[36] In *General Motors*, which followed *Chrysler*, the court similarly found that the section 363 sale was not a *sub rosa* plan when it merely brought value to the estate without dictating the terms of a plan (and assuming only certain liabilities did not make the sale a *sub rosa* plan).[37]

Notes

34 *Id.* at 939-40.

35 In recent cases, section 363 sales were deemed *sub rosa* plans when they benefitted insiders of the debtor to the detriment of creditors. See *In re Oakwood Country Club, Inc.*, No. 10-60246, 2010 WL 4916436 (Bankr. W.D. Va. April 6, 2010); *In re Cloverlear Enter.*, No. 09-20056, 2010 WL 1445487 (Bankr. D. Md. April 02, 2010).

36 *In re Chrysler LLC*, 405 B.R. 84, 97-100 (Bankr. S.D.N.Y. 2009).

37 *In re General Motors Corp.*, 407 B.R. 463, 495-98 (Bankr. S.D.N.Y. 2009).

Data Power Systems Ltd and others v Safehosts (London) Limited and another, Administration Order Prevented by a Lack of Evidence that the Statutory Purpose was Achievable

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Introduction

On 17 May 2013 judgment was handed down in *Data Power Systems Ltd and others v Safehosts (London) Limited and another.*[1] Mr Justice Barker ('Barker J'), sitting in the Chancery Division of the High Court refused an application for an administration order against Safehosts (London) Limited ('SLS') and instead appointed a provisional liquidator to SLS on the basis that there was no substantive evidence that any of the statutory purposes of administration could be achieved.

Court's power to make an administration order

An administrator may be appointed to an insolvent company by the court pursuant to paragraph 11, Schedule B1 of the Insolvency Act 1986 ('IA 1986') following an application by the company, the directors of the company or one or more creditors of the company.

On hearing an application for an administration order the court has several options including, but not limited to, making the administration order sought, dismissing the application, adjourning the application or treating the application as a winding-up petition.[2]

Paragraph 11, Schedule B1, IA 1986 states that in order to grant an administration order the court must be satisfied that: (a) the company is or is likely to become unable to pay its debts;[3] and (b) that the administration order is reasonably likely to achieve the purpose of administration.

The purpose of administration

The purpose of administration is set out in Paragraph 3(1), Schedule B1, IA 1986 which provides that an administrator of a company must perform his functions with the objective of:

a) rescuing the company as a going concern;

b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration); or

c) realising property in order to make a distribution to one or more secured or preferential creditors.

In order to be satisfied that the purpose is reasonably likely to be achieved the courts have applied the 'real prospect' test set out by Hoffman J in *Re: Harris Simons Construction Ltd.*[4] Hoffman J held that it was sufficient that the court should consider that there was a 'real prospect' that one or more of the statutory purposes might be achieved. The 'real prospect' test was confirmed by Lewison J in *Re: AA Mutual International Insurance Co Ltd*[5] and in the recent case of *Auto Management Services Ltd v Oracle Fleet UK Ltd*[6] Warren J said that if the result from an administration were reasonably likely to be better than the result from a liquidation, in all but the most unlikely circumstances, this would be a significant influence on the court to decide in favour of administration.

Data Power Systems Ltd – the facts

SLS was incorporated on 31 October 2011 as a joint venture vehicle to establish and operate a data

Notes

1 [2013] EWHC 2479 (Ch).
2 Paragraph 13, Schedule B1, IA 1986.
3 This case review does not consider the requirements of an entity's ability to pay its debts as this was not in dispute at the hearing.
4 [1989] 1 W.L.R. 368.
5 [2004] EWHC 2430 (Ch).
6 [2007] EWHC 292 (Ch).

centre facility at its registered office at County House in London. SLS leased the office at County House from Wandsloe Pension Scheme ('WPS'), the freehold owner. WPS was a pension scheme set up for the benefit of Mr Pearlman ('Pearlman') and his wife. Pearlman was a trustee of WPS as well as a director of SLS.

The installation of the data centre was never completed and there was no conclusive evidence as to the extent to which SLS had been trading, if at all. An application was made by Data Power Systems Limited ('DPS'), Alisdair James Findlay ('Findlay') and Safehosts Limited ('Safehosts') all of whom claim to be creditors of SLS (the 'Applicants'). Safehosts was also a 50% shareholder in SLS. SLS had not created any fixed or floating charges over its assets and until the date of the application had not been subject to any prior insolvency proceedings.

Exhibited to the Applicants' application was an estimated statement of affairs prepared by Findlay as at 25 March 2013. According to this statement of affairs SLS had estimated assets of approximately GBP 1 million but debts of almost GBP 1.7 million. This deficit was even greater if the plant and machinery assets were to have the 'estimated to realise' value attributed to them as this reduced their value from a cost value of GBP 1million (approx.) to GBP 180,000.

The statement of affairs also showed that Pearlman was the largest creditor of SLS in his personal capacity by virtue of a director's loan of GBP 1.26 million to SLS. WPS was also a creditor of SLS and was owed GBP 87,500.

Pearlman sought to intervene in the application and, although he agreed that SLS was insolvent and that an administrator should be appointed, he sought to appoint different administrators to the administrator proposed by the Applicants.

Issues before the court

The issues before the court were: (i) whether an administrator should be appointed to SLS pursuant to paragraph 11, Schedule B1, IA 1986; and (ii) if the appointment of an administrator could not be made then what powers were available to the court in making an order.

Barker J's decision – was the purpose of administration achievable?

Barker J saw the application and subsequent intervention as 'a turf war' between two factions within SLS who are, or claimed to be, creditors and who are interested, directly or indirectly, in SLS as shareholders.

Barker J was convinced by the evidence and the arguments of either side that the company was unable to pay its debts and therefore part (a) of Paragraph 11, Schedule B1, IA 1986 was satisfied. However, Barker J questioned whether part (b) of Paragraph 11 could be satisfied. He was concerned as to whether one of the purposes of administration could be achieved if an administrator were to be appointed to SLS.

In his judgment Barker J took each of the statutory purposes in turn and addressed the issue of whether sufficient evidence had been provided to the court to enable it to make an administration order.

Rescuing the company as a going concern

Barker J stated that in the case of a company being rescued as a going concern the court must be presented with evidence that either it is capable of being returned to being a going concern or, in a case like SLS, where the company has not traded, that it is capable of becoming a going concern.

Barker J noted that the application had been issued on 23 March 2013 and had been adjourned on 7 May 2013 giving the Applicants and Pearlman '... ample time for any appropriate evidence ...' to be produced to the court. The Applicants first referred Barker J to a statement of Findlay in his witness statement stating that he believed that an administration is reasonably likely to achieve the rescue of SLS as a going concern. Barker J held that this was simply an assertion by Findlay with no underlying reasoned basis.

The Applicants next referred Barker J to a letter from TVCatchup regarding a possible business venture but Barker J noted that it was undated and that the venture was contemplated only on the express basis that SLS were not to enter administration and therefore the letter could not demonstrate that SLS could be rescued.

The Applicants finally referred Barker J to a forecast prepared by Findlay but Barker J held the forecast to be '... merely numbers on a piece of paper and of no greater evidential value than that ...' based on the fact that there are no assumptions given or any guidance or evidence at all on how the numbers were calculated.

Overall Barker J was not satisfied that sufficient evidence had been presented for the court to demonstrate that the first purpose of administration was achievable.

Achieving a better result for the company's creditors as a whole

The Applicants referred Barker J to the statement of Pearlman in his witness statement that the administration would be in the best interests of the company's creditors. However, Barker J held that, as with Findlay's statement, this statement was nothing more than an assertion. Barker J could see no evidence at all that creditors would benefit if SLS was placed into administration.

Conversely, Barker J highlighted that the evidence in fact indicated that the likelihood is that, once the costs of an administrator are taken into account, there will be nothing left for the unsecured creditors. Based on this evidence Barker J was not satisfied that the second purpose of administration was achievable.

As noted previously SLS had no secured creditors or preferential creditors and so Barker J did not need to consider the third purpose of administration.

On the basis that no evidence had been presented to show that the purpose of administration could be achieved Barker J held that paragraph 11(b) of Schedule B1, IA 1986 could not be satisfied and an administration order could not be made. Barker J emphasised to the Applicants and Pearlman that paragraph 11(b) '… is not merely a formality capable of being satisfied by assertion unsupported by cogent credible evidence …'.

Barker J's decision – power to appoint a provisional liquidator

Upon deciding that an administration could not be made Barker J considered the courts' other powers under paragraph 13, Schedule B1, IA 1986.

Barker J recognised that the company was 'hopelessly insolvent' and the application should not simply be dismissed. Barker J also rejected the prospect of adjourning the hearing to a later date as it was an unattractive prospect given that the essence of administration is speed and there had already been one adjournment and no sufficient evidence provided to support the application or intervention.

Barker J held that the proper course of action would be to treat the application as an application for a winding-up petition pursuant to Paragraph 13(e), Schedule B1, IA86.

Paragraph 13(e) states that if the court decides to treat an application as a winding up petition then the court will have the power to make any order that it might make at a hearing of such petition under section 125, IA 1986. Section 125, IA 1986 gives the court a wide discretion to make a winding up order or any other order that it sees fit.

As can be seen the power of the court to make an order under s.125 IA86 is very wide and has included circumstances where the court has wound up 'a hopelessly insolvent' company to allow for an investigation into the company's affairs to take place.[7]

In the case of *Re: Integral Ltd*[8] the court held that the supporting evidence to the application for an administration order was both unreliable and misleading and so ordered the company to be wound up instead.

In the case of SLS it was clearly apparent that the company was insolvent but Barker J held that the proper course would be to first appoint a provisional liquidator in order that a neutral person could come in and take over the company and be charged with realising its assets to raise as much as possible for distribution to creditors. In most cases concerning the appointment of a provisional liquidator, it is usually a foregone conclusion that a winding-up order will eventually be made.[9] In this case Barker J directed that the provisional liquidators appointed would be the insolvency practitioners nominated by Pearlman.

Commentary

The decision highlights that even where a company is clearly insolvent the making of an administration order is not just a simple formality but a process that requires the applicant to substantiate an application with evidence as to lead the court to be satisfied that one of the statutory purposes of administration is reasonably capable of being achieved.

The decision further highlighted that an application for an administration order that is only supported by a statement from a qualified insolvency practitioner in the absence of other evidence is not enough to satisfy a court that one of the purposes of administration is reasonably capable of being achieved.

It is interesting to compare this decision to an out-of-court appointment of an administrator where a statement from the proposed administrator without any further evidence is sufficient to satisfy the requirement that the purpose of administration is achievable. This would imply that there is a higher evidential burden in a court application for an administration order than for an out-of-court appointment of an administrator.

Barker J's decision also highlights that the court has a wide range of powers under both paragraph 13, Schedule B1 and s.125 IA 86 if the court treats the application for an administration order as a winding-up petition. Both provisions of the IA 86 allow the court to make any order that it thinks fit in respect of the application (or winding up petition) and interestingly this has previously included the appointment of a provisional liquidator, despite no such application being before the court for the appointment.

Notes

7 *Bell Group Finance (Pty) Ltd v Bell Group (UK) Holdings Ltd* [1996] B.C.C. 505.
8 [2013] EWHC 164 (Ch).
9 *HMRC Commissions v Rochdale Drinks Distributors Ltd* [2011] EWCA Civ 1116.

Chapter 15 Debtors Need Not Avoid New York: The Requirement of Having Property in the US to Obtain Recognition of a Foreign Proceeding is a Small Bump on the Road[1]

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In *Barnet v Fletcher (In re Barnet)*, 737 F.3d 238 (2d Cir. 2013), a matter of first impression, the United States Court of Appeals for the Second Circuit ruled that Bankruptcy Code section 109(a) applies to a foreign debtor in chapter 15, which means a foreign debtor must show it has a domicile, a place of business, or property in the United States ('US') to have its foreign proceeding recognised.[2] The decision created significant uncertainty regarding the level of scrutiny imposed by the new requirement, which could have persuaded foreign debtors to avoid New York and commence chapter 15 cases in bankruptcy courts in other Circuits.[3] Luckily, it didn't take long for the implications of the decision to be clarified. In its second attempt to recognition following the decision in *Barnet*, Octaviar Administration Pty Ltd ('Octaviar') overcame the newly imposed hurdle with (i) claims and causes of action against US entities, and (ii) a retainer held by Octaviar's US counsel, which were sufficient to satisfy the property requirement embedded in Bankruptcy Code section 109(a).[4] The (unsurprisingly) broad interpretation of 'property in the US' may reassure potential foreign debtors that the Second Circuit's additional recognition requirement is by no means an insurmountable obstacle – especially for foreign debtors with pre-existing presence in the US.

1. Background[5]

Octaviar, an Australian company, was placed into external administration in Australia on 3 October 2008. About a year later, the Supreme Court of Queensland ordered the liquidation of Octaviar. On 13 August 2012, Octaviar's foreign representatives (the liquidators in the Australian proceeding) filed a petition for recognition (the 'First Petition') as a foreign main proceeding with the United States Bankruptcy Court for the Southern District of New York (the 'Bankruptcy Court'). The foreign representatives stated Octaviar did not transact business or have any operations or creditors in the US, but they were seeking chapter 15 recognition to investigate and prosecute potential claims and causes of action against entities located in the US.[6] The recognition order was entered on 6 September 2012, over the objection of Drawbridge Special Opportunities Fund LP ('Drawbridge'). Drawbridge had an interest in the case as a potential target of claims,[7] given that the foreign representatives had already commenced litigation in Australia against its affiliates to recover assets for the benefit of Octaviar's creditors. Drawbridge appealed from the order granting recognition, focusing on whether a foreign debtor under chapter 15 has to satisfy Bankruptcy Code 109(a)'s requirement that a debtor reside, or have a domicile, place of business, or property in the US as a condition to obtaining recognition of a foreign main proceeding. On 11 December 2013, the United States Court of Appeals for the Second

Notes

1 The views expressed herein are solely those of Ms Zerjal, and not necessarily the views of Proskauer Rose LLP or any of its attorneys.
2 For a discussion on *Barnet v Fletcher (In re Barnet)*, 737 F.3d 238 (2d Cir. 2013), *see* Maja Zerjal, '*Barnet* Raises the Bar for Chapter 15 Recognition in the Second Circuit' (2014) 11 *International Corporate Rescue* 116.
3 The United States Bankruptcy Court for the District of Delaware, for example, disagreed with the conclusion in *Barnet* and opined the United States Court of Appeals for the Third Circuit would likely not follow *Barnet* either. *In re Bemarmara Consulting A.S.*, Case No. 13-13037 (KG), Transcript of Hearing at 8:14-25, 9:1-18 (Bankr. D. Del. Dec. 17, 2013).
4 *In re Octaviar Admin. Pty Ltd.*, Case No. 14-10438 (SCC), 511 B.R. 361, 2014, Bankr. LEXIS 2697 (Bankr. S.D.N.Y. 2014).
5 *See id.* for reference.
6 Verified Petition, *In re Petition of Katherine Elizabeth Barnet and William John Fletcher, as Liquidators of Octaviar Administration Pty Ltd*, Case No. 12-13443 (Bankr. S.D.N.Y. Aug. 13, 2012) [Docket No. 2].
7 After the first recognition order, the foreign representatives filed a motion seeking discovery from Drawbridge, among others. *In re Barnet*, 737 F.3d at 241.

Circuit ruled in *Barnet*[8] that Bankruptcy Code 109(a)'s property requirement does apply to foreign debtors. Finding that Octaviar's foreign representatives made no attempt to demonstrate Octaviar had a domicile, place of business, or property in the US, the Court of Appeals vacated the order granting recognition to Octaviar's foreign proceeding, and remanded the case to the Bankruptcy Court.

On 27 February 2014, Octaviar's foreign representatives commenced a new chapter 15 case by filing a modified petition for recognition (the 'Second Petition').[9] The foreign representatives stated that Octaviar held property in the US in the form of (i) claims and causes of action against entities located in the US to be pursued 'in the immediate future', and (ii) an undrawn retainer with the foreign representatives' US counsel in the amount of USD 10,000 deposited in a client trust account with a bank in New York. Drawbridge objected, arguing, among other things, that (i) Octaviar failed to satisfy section 109(a)'s property requirement, (ii) the Second Petition was an abuse of process, and (iii) the case should be dismissed pursuant to Bankruptcy Code 305(a)(2), which provides that a court may, after notice and a hearing, dismiss or suspend a bankruptcy case if a chapter 15 petition has been granted and 'the purposes of Chapter 15 of this title would be best served by such dismissal or suspension.'[10]

2. Claims and causes of action and a retainer are 'property in the US' for purposes of Bankruptcy Code 109(a)

In addition to satisfying the requirements for recognition set forth in Bankruptcy Code sections 1515 and 1517,[11] the Bankruptcy Court held that Octaviar's claims and causes of action and the undrawn retainer were sufficient 'property' to satisfy the requirement of Bankruptcy Code section 109(a).

The Bankruptcy Court began its analysis with Octaviar's claims and causes of action against entities located in the US, which were the main purpose of the chapter 15 filing (as already stated in the First Petition). In addition, the foreign representatives sought recognition to avoid litigation regarding their standing to bring such action in the US. The Bankruptcy Court found the claims and causes of action satisfied the requirements of section 109(a), noting that it was 'well established that ... though intangible, [claims and causes of action] constitute "property."'[12] Drawbridge argued that Octaviar's claims were merely 'potential future causes of action' at the time of the First Petition, but the Bankruptcy Court avoided a discussion of whether potential or future cause of action satisfied the property requirement at the time of the First Petition, and, instead, focused on the time the Second Petition was filed.[13] At that time, the foreign representatives had already commenced litigation against Drawbridge and other related US entities in both the United States District Court for the Southern District of New York and in New York State Supreme Court – at which point the claims and causes of action were no longer 'potential' or 'future'.[14] Drawbridge also argued that the intangible claims and causes of action do not constitute property located in the US, but rather in Australia, since the plaintiff was domiciled in Australia. The Bankruptcy Court dismissed this argument, finding that the litigation involved US entities that were subject to a US court's subject matter and personal jurisdiction, which meant the claim was 'present in that court' (*i.e.*, in the federal district and state court located in New York).[15]

The Bankruptcy Court made clear that the claims and causes of action alone would have sufficed to meet the requirement of Bankruptcy Code section 109(a), but nevertheless analysed the retainer held by Octaviar's US counsel and pointed to a line of authority that acknowledged prepetition retainers as property sufficient to meet the requirement of section

Notes

8 *See supra* note 2.

9 Verified Petition Under Chapter 15 for Recognition of a Foreign Proceeding, Case No. 14-10438 (SCC) [Docket No. 2].

10 11 U.S.C. § 305(a)(2).

11 Bankruptcy Code sections 1515 and 1517 provide the requirements that must be met for recognition: (i) a proceeding must be a foreign main proceeding or a foreign nonmain proceeding; (ii) the foreign representative applying for recognition is a person or a body; and (iii) the petition for recognition must comply with certain procedural requirements set forth in section 1515.

12 *In re Octaviar Admin. Pty Ltd.*, Case No. 14-10438 (SCC), 2014 Bankr. LEXIS 2697, *20 (internal citations omitted).

13 The timing of determination – at the time the petition at issue is filed – is consistent with the approach in *Morning Mist Holdings Ltd. v Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127 (2d Cir. 2013), which set the timing of a 'centre of main interest' determinations to the moment a chapter 15 petition is filed, rather than a period before the filing. Even though the determinations of the centre of main interest and the requirements for recognition are separate processes, the reasoning supporting *Fairfield Sentry* could be applied to the timing of the consideration of the recognition requirements.

14 *See Katherine Elizabeth Barnet and William John Fletcher, as Liquidators of Octaviar Administration Pty Ltd (in Liquidation) v Drawbridge Special Opportunities Fund LP, et al.*, Civ. No. 14-1376 (S.D.N.Y. Feb. 27, 2014) and *Katherine Elizabeth Barnet and William John Fletcher, as Liquidators of Octaviar Administration Pty Ltd (in Liquidation) v Drawbridge Special Opportunities Fund LP, et al.*, Index No. 650656/2014 (N.Y. Sup. Ct. Feb. 28, 2014).

15 *In re Octaviar Admin. Pty Ltd.*, Case No. 14-10438 (SCC), 2014 Bankr. LEXIS 2697, *27-28 (internal citations omitted).

109(a).[16] The USD 10,000 retainer, placed in a trust account a month before the filing of the Second Petition, was disputed by Drawbridge as being an attempt to 'manufacture eligibility'.[17] These allegations were dismissed because (i) the retainer had a legitimate economic function; and (ii) the foreign representatives acted in good faith in placing the retainer in the trust account.[18]

The Bankruptcy Court's liberal interpretation of 'property in the US' in section 109(a) does not come as a surprise: it is consistent with jurisprudence that has required only nominal amounts of property to be located in the US to satisfy section 109(a), creating 'virtually no formal barrier' to the adjudication of foreign debtors' proceedings.[19] The Bankruptcy Court based its decision on the plain meaning of the statute. In that spirit, it refused to take into consideration Drawbridge's allegations that Octaviar's assets were either insufficient or manufactured to meet the additional requirement set forth in *Barnet* by stressing that section 109(a) *does not say anything about the amount of property or the circumstances surrounding the debtor's acquisition of such property.* Such reading is 'consistent with other provisions of the [Bankruptcy Code] that reject lengthy and contentious examination of the grounds for a bankruptcy filing.'[20]

Finally, Drawbridge asserted that the proper forum for Octaviar's actions was in Australia, and that the foreign representatives were merely trying to duplicate existing litigation in Australia by filing a chapter 15 petition in the US. The Bankruptcy Court fired back that the US was actually the only forum available to the foreign representatives, because Drawbridge refused to consent to jurisdiction in Australia. Accordingly, recognition of Octaviar's foreign proceeding promoted the policy and purposes behind chapter 15 by opening the doors to a forum in which to assert claims on behalf of Octaviar's creditors. Indeed, as the Bankruptcy Court also pointed out, there is authority that a foreign representative may first need to seek recognition under chapter 15 before commencing broad litigation in the US.[21]

Conclusion

Octaviar provides valuable insights to prospective foreign debtors considering a chapter 15 filing in New York or other bankruptcy courts within the Second Circuit. Although *Barnet* had the ability to cause a chilling effect due to a seemingly increased standard for recognition of foreign proceedings, prior decision interpreting section 109(a) and *Octaviar* show that the 'property in the US' requirement is not a difficult one to meet. The decision, however, should not lead anyone to believe any kind of property in any kind of circumstances will guarantee recognition in a chapter 15 case. Judge Chapman made clear in *Octaviar* that '[i]n appropriate cases – not this one – there is ample authority under section 305 of the Bankruptcy Code to dismiss or abstain in a case that should not be kept there.'[22] This, coupled with the reminder that '[c]ourts have been careful to recognise that existence of minimal property in the United States does not necessarily mean that a domestic case should be sustained' (discussing *Yukos Oil* and *Global Ocean Carriers*)[23] may be an implicit message that while there is no criteria for the form or amount of property in the US required by section 109(a), these assets have to be sustained by a real interest in the US to ensure a successful case under the Bankruptcy Code.

Notes

16 *See, e.g., In re Cenargo Int'l PLC*, 294 B.R. 571, 603 (Bankr. S.D.N.Y. 2003); *In re Yukos Oil Co.*, 321 B.R. 396, 401-03 (Bankr. S.D. Tex. 2005); *In re Global Ocean Carriers Ltd.*, 251 B.R. 31, 39 (Bankr. D. Del. 2000).

17 *In re Octaviar Admin. Pty Ltd.*, Case No. 14-10438 (SCC), 2014 Bankr. LEXIS 2697, *30, 32.

18 *In re Octaviar Admin. Pty Ltd.*, Case No. 14-10438 (SCC), 2014 Bankr. LEXIS 2697, *30.

19 *See e.g. GMAM Investment Funds Trust I v Globo Comunicacoes E Participacoes S.A. (In re Globo Comunicacoes E Participacoes S.A.)*, 317 B.R. 235 (S.D.N.Y. 2004), citing *In re Aerovias Nacionales de Colombia S.A. (In re Avianca)*, 303 B.R. 1, 9 (Bankr. S.D.N.Y. 2003) (quoting 2 L. King, Collier on Bankruptcy, P109.02[3] (15th ed. rev. 2003)); *Maxwell Communication Corp. plc v Societe Generale plc (In re Maxwell Communication Corp.)*, 186 B.R. 807, 818-19 (S.D.N.Y. 1995), *aff'd*, 93 F.3d 1036 (2d Cir. 1996).

20 *In re Octaviar Admin. Pty Ltd.*, Case No. 14-10438 (SCC), 2014 Bankr. LEXIS 2697, *32.

21 *See* 11 U.S.C. § 1509(b); *United States v J.A. Jones Constr. Group, LLC,* 333 B.R. 637 (E.D.N.Y. 2005); *Reserve Int'l Liquidity Fund, Ltd. v Caxton Int'l Ltd.,* 2010 U.S. Dist. LEXIS 42216, 2010 WL 1779282, at *5 (S.D.N.Y. Apr. 29, 2010).

22 *In re Octaviar Admin. Pty Ltd.*, Case No. 14-10438 (SCC), 2014 Bankr. LEXIS 2697, *32.

23 *In re Octaviar Admin. Pty Ltd.*, Case No. 14-10438 (SCC), 2014 Bankr. LEXIS 2697, *30-33.

Impacts of the Graham Review into Pre-pack Administration in the UK

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The UK Department for Business Innovation & Skills commissioned Teresa Graham CBE, a senior accountant, to perform a review of the current process for pre-packaged sales in administration ('pre-packs'), which was published on 16 June 2014.[1] The review recommends a package of six reforms to address the lack of transparency surrounding current practice with the aim of allaying a number of concerns, notably among unsecured creditors. Although the review highlights a number of shortcomings in the pre-pack process, it concludes that pre-packs still have a place in the UK's insolvency landscape. Rather than an abolition of current practice, Graham advocates a 'clean-up' of the perceived failings and has made a number of recommendations which the UK Government looks set to implement.

Background

Pre-packs have developed as a market technique used by insolvency practitioners to aid corporate rescue.[2] The process aims to achieve optimal realisation from the sale of the insolvent company in situations where it cannot be rescued as a going concern. This involves negotiating and agreeing the sale of a company's business or assets prior to it entering a formal insolvency process, with the sale then being executed concurrently with, or immediately after, the appointment of the administrator. The sale is often completed with limited formal marketing of the business or assets being sold. As such, many unsecured creditors are unaware of the reorganisation plan for the company concerned until it has already been executed.

Although not covered by legislation as such, pre-packs are currently subject to the 'New' Statement of Insolvency Practice 16 – Pre-Packaged Administrations ('SIP 16') issued by the Joint Insolvency Committee.[3] SIP 16 sets out guidelines for UK administrators on best practice when conducting pre-packs. It stipulates that the administrator must provide an explanatory statement detailing the reasons for executing the pre-pack along with the first notification to creditors. The New SIP 16 requires (i) a statement of transaction confirming that the interests of the creditors have been observed and the sale price is the best that can reasonably be achieved; (ii) the statement of transaction must be provided within seven days of the sale; and (iii) a set of disclosure requirements, such as detailing the outcome of marketing activities and summarising the valuation methodology. The New SIP 16 is effectively bridging the gap between the Old SIP 16 and further changes which the review seeks to implement. The major shortcoming of the New SIP 16 is that it does not go far enough to address the problems associated with the Old SIP 16. Unsecured creditors remain in an often marginalised position in a pre-pack deal and criticism includes perceived failure to achieve the best value for the business due to lack of viable marketing.

When used responsibly pre-packs are an effective tool for enabling viable businesses to stay afloat by ensuring the company remains trading and thus preserving both value and jobs. However they have attracted considerable criticism due to their potential for abuse in deals 'behind closed doors'. What is perceived to happen in such scenarios is that the insolvent company sells the business or its assets to one or more of its original directors and/or shareholders at a substantial discount without the knowledge or consent of its unsecured creditors who will be left with a claim against an insolvent company from which the performing or valuable assets have been cherry-picked. Such a perception has led some commentators to claim that pre-packs can replicate the effects of phoenixism, an illegal process whereby the same company essentially reforms without any redress to its creditors. The perception is

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1 Pre-packs also occur in some cases of liquidation; however, the review seeks only to amend the process for pre-packs in administration.

2 Notwithstanding that no legislation or regulation is directly applicable to pre-packs, administrators must be licenced insolvency practitioners and as such, they must have regard to SIPs including SIP 16.

3 The 'New' SIP 16 replaced the 'Old' SIP 16 on 1 November 2013. For further details, please refer to: C. Daly and I. Mokhtassi, 'SIP 16: Out with the Old and in with the New?' (2013) 10:6 *ICR* 370-371.

that the primary beneficiary of the pre-pack process is usually someone who is responsible for the company's insolvency in the first place, frequently the director.

The review also noted cases cited by stakeholders of 'serial pre-packing' where the controlling parties had engaged in a succession of pre-packs. Such administrations are highlighted by Graham as a debt avoidance tactic rather than as rescue tools. Although the data analysed in the review suggests that poor practice is not widespread, the above perceptions are a particularly prevalent concern for 'Connected Party' pre-packs. Connected Parties include, for the purposes of Graham's review, those individuals having connections to, or controlling interests in, the company subject to the pre-pack. The definition excludes sales to secured lenders holding security over the shares of both the new and old company as part of their normal course of business.

In response to the outlined concerns, Graham's review was commissioned to independently investigate the process as part of the UK Government's wider 'Transparency and Trust' agenda. The review analysed data from several sources including qualitative information provided by interested stakeholders and empirical evidence provided by a commissioned report conducted on 499 randomly selected companies that executed pre-packs in 2010, carried out by the University of Wolverhampton. It forms the first large-scale independent analysis of recent data, establishing a '*robust and up-to-date baseline on pre-pack administrations*'. Thus the review has provided an unprecedented footing for accurate, independent comment on the current situation. The report splits into four positive and negative findings which are discussed below.

The review's positive findings

The review uncovered the following positive aspects of pre-packs:

The preservation of jobs

The company remains trading which benefits unsecured creditors by reducing claims against the insolvent company. The empirical evidence revealed that many of the administrator's explanations for pre-pack sales cited preservation of employment as one of the reasons for undertaking the pre-pack. Graham observes that the benefit is often viewed as preservation of the jobs themselves, but more often it is actually achieving a reduction in the preferential and unsecured creditor claims had the employees been made redundant as a result of the old company's insolvency. Saving jobs is furthermore important for other creditors, including floating charge holders, as part of the package of liabilities the old company would otherwise owe its employees would be classed as preferential and therefore paid in priority to floating charge holders and unsecured non-preferential creditors. The evidence from the data gathered shows that where all employment was preserved, this was reported to creditors.[4] However, where less than 100% employment preservation was achieved the situation is less clear, as below this threshold the category merely recorded that 'some' was preserved, or else this evidence was not submitted. Despite this, it seems clear that the majority of pre-packs do indeed preserve jobs.

Relatively cheaper cost than alternative upstream insolvency procedures

There is a significant cost advantage of executing a pre-pack when compared to other pre-insolvency procedures such as schemes of arrangement or company voluntary arrangements. A scheme of arrangement, in particular, is typically only undertaken by large companies and involves a compromise or agreement between a company and its members or creditors or any class of them, under Part 26 of the Companies Act 2006. Graham cites the cost of a scheme as typically being three times more than the cost of fees associated with a pre-pack for the same company. This is owing to the greater involvement of the court and creditors. Conversely pre-packs can be executed outside court and without the involvement of unsecured creditors (or merely their limited involvement).

Deferred consideration is largely paid

Deferred consideration allows the purchaser to pay for the business over a period of time rather than at the date of purchase, with or without an upfront cash payment. The data analysed by Graham found that over half of all sales involved an element of deferred consideration and this was fully paid in nearly 90% of cases when payment was required within six months of the sale, such that creditors were not unduly harmed.

Benefit to the UK economy overall

The UK has a flexible insolvency, restructuring, and company legislative framework which renders it an attractive place to conduct business and relocate to. The

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4 This was the case for 318 of the 499 companies in the study which executed a pre-pack sale.

research found that only 6 of the 499 companies in the sample group were registered overseas (five of which were part of the same group), so instances of overseas companies relocating their centre of main interest to the UK solely to take advantage of the pre-pack offering seem to be few. Nonetheless, Graham notes that stakeholders are of the opinion that the volumes have increased since 2010, so there may be some limited but potentially growing benefit to the UK economy.

Notwithstanding the positive factors listed above, Graham identified the following 'negative' aspects of current pre-pack practice which require improvement despite the implementation of New SIP 16 in November 2013.

Areas of improvement for current practice

Lack of transparency

As noted above, unsecured creditors typically do not find out about the pre-pack until it has been completed leaving them disenfranchised, particularly when the purchaser is a Connected Party. Increasing transparency of the process would improve stakeholder and market confidence.

Insufficient marketing of pre-pack companies for sale

Despite the marketing obligations contained in Old SIP 16, more than one third of the companies surveyed in the review had no clear evidence for when marketing was conducted nor for how long. The evidence also showed that companies who conducted no marketing reported lower returns to creditors. As such, better marketing could improve creditors' perceptions of whether they are getting the best deal.

Insufficient valuation of assets

Independent valuations appear to be desk-top valuations only and, where there is a Connected Party sale, the purchase price often corresponds exactly to this figure. Consequently this raises the suspicion that the figure is merely an indication of the price the purchaser is willing to pay.

Absence of consideration for the future viability of the new company

This is not a concern of the insolvency practitioner as his duty is towards the creditors of the insolvent company, rather than to the viability of the new company.

Recommendations

The review found that pre-packs to Connected Parties are more likely to fail than pre-packs to unconnected parties, and are consequently less likely to produce a return for unsecured creditors. Graham makes two recommendations specifically tackling pre-packs involving sales to Connected Parties and four additional recommendations applying to all pre-packs which are designed to bolster good practice. The two recommendations which concern Connected Parties are:

1. Pre-pack Pool

On a voluntary referral basis, a Connected Party purchaser should approach a pre-pack pool of independent and experienced business professionals one of whom will act as expert to review the terms of the proposed deal and opine on its reasonableness.[5] If the expert issues a negative statement on the pre-pack, the deal may still continue without clearance but the administrator must record this in the explanatory statement of the pre-pack provided with the first notification to the creditors.

This proposal aims to ensure independent scrutiny of the pre-pack before its execution but with minimal public exposure which might otherwise damage the business. Graham envisages that pool members will be selected across a range of disciplines and industries established and administered by a small secretariat, with cases allocated on a rotation basis. Fees would be payable by the Connected Party for the costs of both the secretariat and the time of the pool member, the latter being on a fixed-fee basis rather than a time basis. However there is little further information provided beyond this and as yet it remains unclear how the pool would work in practice.

2. Viability Review

The Connected Party should issue a viability statement that the new company will remain a going concern for at least twelve months, again on a voluntary basis. It

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5 In practice, the insolvency practitioner will need to ascertain whether the Connected Party has approached the pre-pack pool and, where they are unaware of the pool, he will need to inform them of it and encourage them to approach it in accordance with Graham's 'Revised' SIP 16 (see below at point 3).

is also suggested that this statement include a short narrative detailing how the new company will perform differently from the insolvent company in order to avoid future failure. The viability review should be attached to the pre-pack explanatory statement or, in its absence, a statement from the insolvency practitioner to the effect that the purchaser has failed to produce a requested viability statement.

Although it is at the discretion of the Connected Party to seek pool clearance, the insolvency practitioner will nevertheless need to justify the pre-pack to the creditors in his initial statement, including: (i) why the Connected Party has not approached the pool for pool clearance, if this is the case; or (ii) if the pool expert has issued a negative statement, the reasons for continuing with the pre-pack; and (iii) if the Connected Party has failed to produce a viability statement, the reasons for this. Accordingly the decision to execute the pre-pack in the absence of either is ultimately a decision for the insolvency practitioner. The remaining four recommendations are of general application and have been partly pre-empted by the changes to SIP 16 in November 2013:

3. 'Revised' SIP 16

The Joint Insolvency Committee should consider amending SIP 16 further to incorporate the above recommendations. A copy of the proposed Revised SIP 16 is annexed to the review and contains the following revisions: (i) it proposes that the statement of pool clearance and the viability review (or statements of the lack thereof) be included with the administrator's explanatory statement and sent with the first notification to creditors; (ii) additional guidelines from the recommendations on marketing and valuation (see below at points 4 and 5) are included to complement those already in SIP 16; and (iii) a number of minor improvements are made to tighten the language used for increased clarity.

4. Marketing

Graham introduces six principles of good marketing which should be complied with prior to a pre-pack sale, with any deviation being brought to the creditors' attention in the administrator's explanatory statement. Graham notes, however, that marketing is not a legitimate option in certain cases where it would harm the creditors' prospects of recovery and such should be noted on the administrator's explanatory statement. In cases where marketing is an appropriate route, the following principles apply:

(i) Broadcast rather than narrowcast to market as widely as is proportionate to the nature and size of the company;

(ii) Justify the media strategy which is used;

(iii) Ensure independence;

(iv) Publicise rather than merely publishing;

(v) Include online communications, or justify why the internet is not used to market if that is the case; and

(vi) Comply or fully explain to all creditors the marketing strategy and how this achieves the best outcome for the creditors.

5. Valuations

A valuation of the company's assets should be carried out by a valuer holding professional indemnity insurance in order to enhance reliability. The insolvency practitioner must provide an explanation if he fails to appoint such a valuer.

6. Monitoring SIP statements

The Insolvency Service should withdraw from monitoring administrators' explanatory statements and such monitoring should instead be conducted by the Recognised Professional Bodies owing to their elevated levels of practical experience.[6]

Implementation

Despite the absence of formal rules, Graham notes that self-regulation is nonetheless '*in all stakeholders' interests, including insolvency professionals, that they are successful*', and it is hoped that the insolvency industry embraces them. If the above recommendations are not adopted and enforced by the market, Graham suggests that the Government should consider legislation and, in the meantime, should draft legislation at the earliest opportunity. The Government looks set to follow Graham's suggestions and has proposed the Small Business, Enterprise and Employment Bill (published on 26 June 2014) that gives power to the Secretary of State to prohibit pre-pack sales to Connected Parties

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6 For the purposes of the review, the list of Recognised Professional Bodies is as follows: (i) The Chartered Association of Certified Accountants; (ii) The Institute of Chartered Accountants in England and Wales; (iii) The Institute of Chartered Accountants of Scotland; (iv) The Institute of Chartered Accountants in Ireland; (v) The Insolvency Practitioners Association; (vi) The Law Society of Scotland; and (vii) The Law Society.

if certain conditions are not met, which is to apply if non-legislative voluntary measures are not sufficiently enforced.

Practical implications

Perhaps the most controversial and radical of the proposed recommendations is the concept of the new pre-pack pool for Connected Parties. It remains to be seen just how this concept will translate into practice, if at all. For the framework to be implemented successfully, it must allow for a cheap and efficient service which increases transparency and addresses the concerns of unsecured creditors. However, there are a number of practical issues which need to be addressed before its implementation. Graham envisages that the pool members will perform services on a fixed-fee basis across no more than half a day. This may be impractical in complex transactions, reducing the task to a headline exercise and discouraging Connected Parties from referring themselves to the pool. In addition, time is often of the essence in pre-packs and the pool is in danger of being redundant if pool members are not available on an urgent basis. This is largely dependent on the business interest in establishing the pool; the problem this poses is lack of interest by those best qualified to perform the service as fees are envisaged to be low and the pool may not attract enough interest to viably run. Lastly, it is not yet clear who is to take responsibility for setting up the pool.

Of the other changes, the requirement for valuations to be undertaken by valuers holding professional indemnity insurance may prove unpopular as it is likely to push the cost of pre-packs up, making them less appealing to smaller companies in particular. Other changes are less contentious as the market has been partially prepared for them through the amendments of New SIP 16. For example, despite the obligation to market the business a degree of flexibility remains for cases where marketing would harm the business' prospects of recovery. As reduced publicity is usually an underpinning motive for using a pre-pack, it remains to be seen if the enhanced marketing obligations are effective.

Conclusion

The review recognises the pre-pack as a valuable corporate rescue tool in UK restructuring and seeks to introduce measures to stamp out poor practice. Industry reaction to the recommendations has largely been positive and it is expected that practitioners will voluntarily adhere to the process. Adherence is likely to be reinforced by the introduction of the Small Business, Enterprise and Employment Bill which makes provision for future legislation should the recommendations not be universally adopted. Some critics have voiced concern that in the absence of statutory force, the new recommendations will lack the necessary strength to tackle bad practice.

However, the review has raised industry focus on the pre-pack process and clarified the strengths and weaknesses of current practice through its unprecedented analysis of recent empirical data. This has undermined many negative preconceptions of pre-packs and reinforced the value they offer to financially distressed companies. It will be interesting to see how practice evolves following the recommendations, particularly if the pre-pack pool is enforced, but for now it would seem that pre-packs between Connected Parties are here to stay.

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