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Madoff: Some Comfort for Foreign Investors Indirectly Investing in U.S. Companies[1]

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In a case stemming from the collapse of the infamous Madoff Ponzi scheme, the Unites States District Court for the Southern District of New York (the 'Court') ruled that foreign entities that indirectly invested in the Madoff fund through foreign feeder funds could not be targeted in avoidance actions brought under the United States Bankruptcy Code ('Bankruptcy Code'). The Court found that Bankruptcy Code section 550(a), which allows a trustee to recover avoided transfers from subsequent transferees, (i) cannot be extended to extraterritorial transactions involving foreign transferees receiving funds from foreign transferors, and (ii) even if section 550(a) could be invoked extraterritorially, in this case, such application would be precluded by international comity.[2]

Background

The massive scale of Madoff's fraud affected investors across the globe. Bernard L. Madoff Investment Securities LLC ('Madoff Securities') was partly funded by so-called 'feeder funds', which pooled their own customers' assets and invested them with Madoff Securities. For example, two foreign custodian banks engaged in asset management (together, 'Foreign Banks') both invested in two of Madoff Securities' largest feeder funds, Fairfield Sentry Limited ('Fairfield') and Harley International (Cayman) Limited ('Harley'),[3] which in turn invested these assets in Madoff Securities.[4]

After the largest, longest-running Ponzi scheme in history was uncovered in December 2008, a liquidation under the Securities Investor Protection Act ('SIPA') was commenced, and Irving H. Picard was appointed trustee ('Trustee') of the Madoff Securities estate. The Trustee commenced several 'avoidance actions', i.e. proceedings under the Bankruptcy Code, SIPA, and other applicable law[5] seeking the avoidance and recovery of certain transfers, including preferences and fraudulent transfers, for the benefit of the debtor's estate. The Trustee settled its avoidance and recovery action against Fairfield, and obtained a default judgment against Harley for more than USD 1 billion.[6]

Proceedings against the Foreign Banks

In October 2011, the Trustee filed adversary proceedings against the Foreign Banks to recover, pursuant to Bankruptcy Code section 550(a)(2), USD 50 million in subsequent transfers of alleged Madoff Securities customer property the Foreign Banks received as a customer of Fairfield and Harley.[7]

Bankruptcy Code section 550(a) provides:

> Except as otherwise provided in this section, to the extent that a transfer is avoided ... the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from--
>
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.[8]

Notes

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

2 *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. 222, 226 (S.D.N.Y. 2014).

3 The unveiling of Madoff's fraudulent scheme triggered the collapse of some feeder funds that were heavily invested in Madoff Securities, including Fairfield and Harley, which each commenced liquidation proceedings in the British Virgin Islands and the Caymans Islands, respectively.

4 *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. at 226.

5 The pertinent provisions include sections 78fff(b), 78fff-l(a) and 78fff-2(c)(3) of SIPA, sections 541, 542, 544, 547, 548, 550, and 551 of the Bankruptcy Code, and sections 273 to 279 of New York Debtor and Creditor Law.

6 *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. at 225-26.

7 *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. at 225.

8 11 U.S.C. § 550(a).

The paramount issue was whether section 550(a)(2) applied extraterritorially to reach subsequent transfers made abroad between foreign entities.

Bankruptcy Code section 550(a)(2) does not reach subsequent transfers made abroad between foreign entities

At the outset of its analysis, the Court cited to a principle set forth in the Supreme Court decision in *Morrison v. Nat'l Australia Bank Ltd.*: 'It is a "long-standing principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States."'[9] Based on this premise, the Court cited a two-factor test to overcome the presumption against extraterritorial application of a statute, which requires a court to consider (i) first, whether the factual circumstances require extraterritorial application, and (ii) if so, whether Congress intended for such statute to be applied extraterritorially.[10]

(i) Do the facts at issue require the relevant statute to be applied extraterritorially?

Application of the Bankruptcy Code is not inherently domestic merely because there is a connection to a U.S. debtor. Relying on *Morrison*, the Court focused on the 'transactions that the statute seeks to regulate'.[11] The Trustee sought to avoid the extraterritorial issue altogether, claiming that any application of SIPA or provisions of the Bankruptcy Code SIPA incorporates were inherently domestic because the purpose of SIPA was to regulate the liquidation of eligible U.S. broker-dealers, and any application of the incorporated provisions would thus be inherently U.S.-related and as such, domestic. The Court disagreed, stating that 'a mere connection to a U.S. debtor, be it tangential or remote, is insufficient on its own to make every application of the Bankruptcy Code domestic'.[12]

Transfers between foreign entities are extraterritorial transactions, even if the chain of transfers originated in the U.S. The Court found that the focus of Bankruptcy Code section 550(a)(2) was the transfer of property to a subsequent transferee, and not the relationship of the property to a debtor. The transfer at issue was purely extraterritorial because it occurred between foreign entities (foreign feeder funds transferred funds to their foreign customers).[13] The fact that the chain of transfers started in New York was irrelevant: such fact was insufficient to recover, pursuant to section 550(a)(2), otherwise completely foreign subsequent transfers.[14] Accordingly, the facts required a foreign application of section 550(a)(2) to reach the transfers between the feeder funds and the Foreign Banks.

(ii) Did Congress intend for the statute to apply extraterritorially?

There is no clear indication in the language of the statute that Congress intended it to apply extraterritorially. In *Morrison*, the Supreme Court explained that there must be an affirmative intention of Congress to give a statute extraterritorial effect, and it must be clearly indicated – absent that, there can be no extraterritorial reach.[15] Looking at the language of section 550(a), the Court concluded there was no 'clear indication' Congress intended it to apply to foreign transfers.[16]

Similarly, Section 78fff-2(c)(3) of SIPA, which empowers a SIPA trustee to use the Bankruptcy Code's avoidance and recovery provisions to reclaim customer property, also does not clearly indicate its ability to be applied extraterritorially (a SIPA trustee may 'recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of [the Bankruptcy Code]'). To the contrary, SIPA's clear domestic focus – it excludes brokers primarily involved in business outside the U.S., and customers whose claims arise out of transactions with foreign subsidiaries of the broker-dealer are not covered – provides support for the notion that Congress *did not* intend for any extraterritorial application.

Notes

9 561 U.S. 247, 255 (2010) (internal citations omitted).
10 *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. at 226 (internal citations omitted).
11 *Id.*
12 *Id.* at 227.
13 *Id.* at 228.
14 *Id.* at 227-28, citing *In re Midland Euro Exch. Inc.*, 347 B.R. 708, 717 (Bankr. C.D. Cal. 2006) (Bankruptcy Code section 548 (fraudulent transfers) was applied extraterritorially where the funds were transferred from a Barbardos corporation to an English corporation, even though the funds were previously transferred through a New York bank); *In re Maxwell Commc'n Corp.*, 186 B.R. 807, 816 (S.D.N.Y. 1995) (Bankruptcy Code section 547 (preferences) was applied extraterritorially where 'the antecedent debts were incurred overseas, the transfers on account of those debts were made overseas, and the recipients ... [are] all foreigners').
15 *Id.* at 228 (internal citations omitted).
16 Courts in *In re Maxwell Commc'n Corp.* and *Midland Euro Exch. Inc.*, *see supra* n. 14, similarly found that the language of Bankruptcy Code sections 547 and 548, respectively, did not express any clear intent to apply these sections extraterritorially.

The Trustee sought to rebut the presumption against extraterritoriality by pointing to Bankruptcy Code section 541, which defines 'property of the estate' as property 'wherever located and by whomever held'.[17] It is well established that 'property of the estate' under Bankruptcy Code section 541 extends to property located anywhere in the world.[18] As 'property' in section 550(a) could be used to help interpret section 541's 'property of the estate wherever located and by whomever held', the Trustee claimed this indirect incorporation proved Congress' intent in allowing extraterritorial application of section 550(a).[19] The Court was not persuaded, however. Transferred property that is the subject of an avoidance action is not 'property of the estate' until it is recovered, so 'section 541 cannot supply any extraterritorial authority that the avoidance and recovery provisions lack on their own'.[20]

Public Policy concerns do not override the presumption against extraterritoriality in this case

The Trustee also argued that public policy concerns mandate the extraterritorial application of section 550(a) – otherwise, a U.S. debtor could fraudulently transfer its assets abroad, and from there, to another foreign subsequent transferee to avoid the reach of the Bankruptcy Code avoidance and recovery powers.[21] However, public policy cannot be broadly used to override the presumption against extraterritoriality and to fill any loopholes in laws. First, the primary policy objective of SIPA – the equitable distribution of customer funds to customers – had not been at issue when defendants (as indirect customers) were not even creditors of the Madoff Securities estate and, therefore, they were not treated more favorably than customer creditors.[22] Second, the unavailability of Bankruptcy Code section 550(a) did not preclude the Trustee from seeking to undo and recover the allegedly fraudulent foreign transfers by utilising laws applicable in the jurisdictions where the allegedly fraudulent transfers occurred, which would also prevent any 'international discord'.[23]

Even if Bankruptcy Code section 550(a) could be applied extraterritorially, such application would be precluded by comity

Even if the presumption against extraterritorial application of the statute could be rebutted, international comity would preclude the use of Bankruptcy Code section 550(a) to reach the foreign transfers at issue.

In view of the ongoing liquidations of the Fairfield and Harley feeder funds, the Court noted that the foreign transfers at issue were also subject to foreign, potentially conflicting rules regarding the disgorgement of certain transfers. Indeed, in the foreign liquidation proceeding of Fairfield, the British Virgin Islands courts already determined that Fairfield could not recover certain transfers made to its customers. Granting the Trustee's request would raise comity concerns, because it would be tantamount to overriding the British Virgin Islands courts' determination.[24]

In sum, the defendants had no reason to expect that their remote and indirect connection to Madoff Securities could invoke their liability under a U.S. statute designed to protect customers of U.S. broker-dealers. The Court concluded that '[g]iven the indirect relationship between Madoff Securities and the transfers at issue ... foreign jurisdictions have a greater interest in applying their own laws than does the United States'.[25]

In re Icenhower: A different interpretation – or not?

Just days before the *Madoff* ruling, the United States Court of Appeals for the Ninth Circuit issued a decision holding, among other things, that Bankruptcy Code sections 549 and 550 could be applied extraterritorially in an action to avoid a postpetition transfer of real estate located in Mexico.[26] *Icenhower*, however, should not spoil the comforting message *Madoff* sent to foreign investors: the two cases are distinguishable in significant ways.

In *Icenhower*, Jerry and Donna Icenhower obtained an interest in a Mexican villa, which they later transferred to H&G, a shell company they purchased to hold

Notes

17 The same argument was made for the mirror provision of SIPA section 78eee(b)(2)(A)(i), which provides for 'exclusive jurisdiction of such debtor and its property wherever located (including property located outside the territorial limits of such court ...'.

18 *See Weber v. SEFCU (In re Weber)*, 719 F.3d 72, 75 (2d Cir. 2013) ('Section 541 gathers into the estate all such interests in property, "wherever located and by whomever held."'); *Int'l Tobacco Partners, Ltd. v. Ohio (In re Int'l Tobacco Partners, Ltd.)*, 462 B.R. 378 (Bankr. E.D.N.Y. 2011) ('Section 541(a) of the Bankruptcy Code defines property of the estate to include "property, wherever located and by whomever held"').

19 *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. at 229.

20 *Id.* at 229 (internal citations omitted).

21 *Id.* at 231.

22 *Id.* In fact, defendants could expect insignificant (if any) distributions through the failed feeder funds they invested in. *Id.*

23 *Id.*

24 *Id.* at 232.

25 *Id.*

26 *Kismet Acquisition, LLC v. Diaz-Barba (In re Icenhower)*, 757 F.3d 1044 (9th Cir. 2014).

the interest in the villa (H&G was later determined to be an alter ego of the Icenhowers). After the Icenhowers filed for bankruptcy, H&G sold the villa for USD 1.5 million. The bankruptcy trustee sought to: (i) avoid the sale from H&G to the purchasers as an unauthorised postpetition transfer avoidable under Bankruptcy Code section 549, and (ii) hold the purchasers liable as initial transferees under Bankruptcy Code section 550(a)(1). The bankruptcy court held the transfer was avoidable, and the District Court and the Circuit Court affirmed.[27] Following the *Morrison* test, the Circuit Court stated that extraterritorial application of the Bankruptcy Code was proper because 'Congress intended extraterritorial application of the Bankruptcy Code as it applies to property of the estate',[28] which is evidenced by the statute granting bankruptcy courts exclusive jurisdiction over 'all the property, wherever located, of the debtor'.[29] Because H&G was the debtors' alter ego, the villa was in fact property of the debtors on the petition date.

While seemingly conflicting, *Madoff* and *Icenhower* differ in certain key aspects. First, the argument regarding extraterritorial reach of the Bankruptcy Code with respect to 'property of the estate' was (unsuccessfully) made by the Trustee in *Madoff*. However, in *Icenhower*, the transfer at issue occurred *postpetition*, when the villa was 'property of the estate'.[30] In *Madoff*, the transfers were made *prepetition* and could not become property of the estate until recovered by the Trustee. Second, the comity concerns expressed in *Madoff* were not equally compelling in *Icenhower*, where the transfers were made by a U.S. debtor, after a U.S. bankruptcy case had been commenced. Third, *Madoff* involved highly sophisticated investments subject to SIPA protections, whereas *Icenhower* dealt with individuals seemingly seeking to shield assets through shell corporations and dubious transfers.

Conclusion

Madoff provides some assurance that claw back powers of the Bankruptcy Code cannot reach purely foreign transactions, even when they originated with a U.S. entity. However, these types of cases are highly fact-specific, so even a slight variance in circumstances may change the outcome. For example, had the Foreign Banks dealt directly with Madoff (even if the transfers were made through an intermediary), the result could have been different. Accordingly, some familiarity with the Bankruptcy Code is recommended even for foreign investors with indirect, perhaps seemingly remote investments in U.S. companies.

Notes

27 In addition to holding the extraterritorial application was proper as it applied to property of the estate, the bankruptcy court also held that alternatively, the sale of the villa was a fraudulent transfer under Bankruptcy Code section 544(b)(1) and California law, and the villa could be recovered from the purchasers as subsequent transferees not in good faith pursuant to section 550(a)(2). *Id.* at 1049. The Circuit Court decision does not seem to analyse this alternative argument.

28 *Id.* at 1050, citing *In re Simon*, 153 F.3d 991, 996 (9th Cir. 1998).

29 28 U.S.C. § 1334(e).

30 *In re Icenhower*, 757 F.3d at 1050-51.

Chapter 15: Expect Section 363 Review of Sales of Property Located in the US

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On 26 September 2014, the United States Court of Appeals for the Second Circuit (the 'Second Circuit') held that bankruptcy courts must review sales of a chapter 15 debtor's property located within the United States ('US') pursuant to Bankruptcy Code section 363, even is such sale has already been approved by the court in the debtor's foreign proceeding.[1] Reversing the decisions of the lower courts, the Second Circuit ruled that a claim against a US debtor is within the territorial jurisdiction of the US, and, accordingly, the sale of such property is subject to mandatory review and approval by the US bankruptcy court in a chapter 15 proceeding.

While seemingly in contrast with previous decisions and comity, the mandatory nature of a US bankruptcy court review of sales of a foreign debtor's property located in the US is not surprising or novel. The decision, however, teaches that foreign debtors should carefully scrutinise what property (especially intangible) is located within the jurisdictional boundaries of the US to correctly predict which sales of property require US bankruptcy court review in a chapter 15 case.

Background

Fairfield Sentry Limited ('Fairfield') was one of the largest feeder funds that invested with Barnard L. Madoff Investment Securities LLC ('BLMIS'). The collapse of BLMIS forced Fairfield into liquidation in the British Virgin Islands ('BVI'). Fairfield's liquidator (the 'Liquidator') later filed a chapter 15 petition in the United States Bankruptcy Court for the Southern District of New York ('Bankruptcy Court') seeking recognition of the BVI liquidation, which was ultimately recognised as a foreign main proceeding.[2] Fairfield filed claims ('SIPA Claim') in the liquidation of BLMIS under the Securities Investor Protection Act ('SIPA'), which were settled and allowed in the amount of USD 230 million, subject to a cash payment of USD 70 million to be paid by Fairfield to BLMIS. The SIPA Claim was an asset in Fairfield's BVI liquidation. The Liquidator held an auction for the SIPA Claim, and ultimately sold it to Farnum Place, LLC ('Farnum') for about a third of the allowed amount. The Liquidator and Farnum negotiated a 'Trade Confirmation' setting forth the terms and conditions of the SIPA Claim sale, including that the transaction was subject to approval by the BVI court and the Bankruptcy Court.

Just days after the sale was finalised, the SIPA trustee announced a settlement that increased the value of the SIPA Claim from 32% to more than 75% of the USD 230 million allowed amount of the claim. In the light of this development, the Liquidator did not go forward with the sale. Farnum, however, sought a BVI court order directing the Liquidator to perform as agreed upon in the Trade Confirmation. The Liquidator asked the BVI court not to approve the sale to Farnum because of the interim increase in value of the SIPA Claim, and argued the Trade Confirmation also required the Bankruptcy Court's approval. The BVI court held an evidentiary hearing and approved the terms of the Trade Confirmation, but deferred to the Bankruptcy Court for issues of US bankruptcy law. Importantly, the BVI court directed the Liquidator to bring the matter to the Bankruptcy Court for approval so that 'the US Bankruptcy Court is presented with a choice whether or not to approve it'.[3]

The Liquidator then filed a motion in the Bankruptcy Court to disavow the Trade Confirmation pursuant to Bankruptcy Code section 363.[4] The Bankruptcy Court, however, refused to review the sale and characterised the Liquidator's request as a 'seller's remorse' and 'last-ditch effort' to undo the transaction.[5] The Bankruptcy Court held that a section 363 review was

Notes

1 *In re Fairfield Sentry Ltd.*, 768 F.3d 239 (2d Cir. 2014).
2 The order of recognition was affirmed by the district court and subsequently by the Second Circuit. *See Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127 (2d Cir. 2013).
3 *In re Fairfield Sentry Ltd.*, 768 F.3d at 243.
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'.

not warranted because a transfer of *property in the US* under Bankruptcy Code section 1520(a)(2) was not invoked (because the SIPA Claim was not property within the territorial jurisdiction of the US) and such ruling was 'consonant with the origins of Chapter 15 and the notion of comity, a central tenet therein.'[6] Based on the principles of justice, convenience and commons sense applicable by New York non-bankruptcy law,[7] 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',[8] and did not require plenary section 363 review. The Liquidator appealed, but the district court sided with the Bankruptcy Court, holding that it wasn't clear whether section 363 applied, but even if it did, the Bankruptcy Court refusal to review the transaction was proper because '[c]ourts should be loath to interfere with corporate decisions absent a showing of bad faith, self-interest, or gross negligence.'[9]

The Second Circuit decision

The primary question for the Second Circuit was 'whether the bankruptcy court was required to conduct a review under section 363, which 'requires that a judge … expressly find from the evidence presented before him at the hearing a good business reason' to approve the sale.'[10] Bankruptcy Code section 1520(a)(2) provides that in a chapter 15 case involving a foreign main proceeding, a bankruptcy court must apply section 363 review to a 'transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States to the same extent that the sections would apply to property of an estate [of a US debtor].'[11] Specifically, the Second Circuit had to determine (i) whether the SIPA Claim was property within the territorial jurisdiction of the US; and (ii) whether considerations of comity required deference to the BVI court approval of the sale, irrespective of whether the SIPA Claim was property within the territorial jurisdiction of the US.[12]

i. The SIPA claim is property within the territorial jurisdiction of the US

The Liquidator argued that the SIPA Claim is an interest in the BLMIS fund, which is property located in the US, and as such, the SIPA Claim is located in the US. Conversely, Farnum argued the relevant property was the SIPA Claim, not the BLMIS fund, and that the SIPA Claim was located in BVI. The Second Circuit agreed the relevant property was the SIPA Claim itself (Fairfield's rights, title and interest in Fairfield's claims against BLMIS), but ruled it was located in the US. The Bankruptcy Court's analysis, which determined the SIPA Claim was located in BVI, was incomplete, because it was based solely on 'common sense appraisal of the requirements of justice and convenience',[13] and failed to consider that Bankruptcy Code section 1502(8) deems 'any property subject to attachment or garnishment that may be properly seized or garnished by an action in' a United States court to be 'within the territory of the United States.'[14] Under New York law, which governed the Trade Confirmation, the SIPA Claim was subject to attachment and garnishment in the US, and could be properly seized by an action in the US. For attachment purposes, the location of intangible property is 'the location of the party of whom that performance is required pursuant to that obligation.'[15] The SIPA Claim required performance by the SIPA trustee in the form of a distribution. Therefore, the *situs* of the SIPA Claim was the location of the SIPA trustee, which was New York. Accordingly, a section 363 review by the Bankruptcy Court was mandatory because the SIPA Claim is property located within the territorial jurisdiction of the US.

ii. Comity does not mandate deference to the BVI court ruling

As an additional reason for refusing to apply section 363 review to the transaction, the Bankruptcy Court noted that comity required deference to the BVI court's ruling approving the sale. The Second Circuit disagreed. Comity did not demand that the BVI court's ruling receive deference because if, as here, Bankruptcy Code section 1520(a)(2) plainly requires a section

Notes

5 *In re Fairfield Sentry Ltd.*, 768 F.3d at 243.
6 *In re Fairfield Sentry Ltd.*, 484 B.R. 615, 622 (Bankr. S.D.N.Y. 2013) (internal citations omitted).
7 The court determined that applicable non-bankruptcy law determines if an intangible interest is within the territorial jurisdiction of the US.
8 *In re Fairfield Sentry Ltd.*, 484 B.R. at 628.
9 *Krys v Farnum Place, LLC (In re Fairfield Sentry Ltd.)*, No. 13 Civ. 1524 (AKH), 2013 U.S. Dist. LEXIS 188911, at *1-*2 (S.D.N.Y. Jul. 3, 2013) (internal quotation marks omitted).
10 *In re Fairfield Sentry Ltd.*, 768 F.3d at 243 (internal citations omitted).
11 11 U.S.C. § 1520(a)(2).
12 *In re Fairfield Sentry Ltd.*, 768 F.3d at 243 (internal citations omitted).

363 review, the Bankruptcy Court could not circumvent its statutory duty by deferring to the BVI court. Moreover, it was not apparent the BVI court 'expects or desires deference', when it 'expressly declined to rule on whether the Trade Confirmation required approval' under Bankruptcy Code section 363.[16] Accordingly, the Second Circuit ruled the Bankruptcy Court erred in deferring to the BVI court's approval of the transaction.

The Second Circuit vacated and remanded the case back to the Bankruptcy Court for a section 363 review, but gave a clear indication that, under the 'good business reason' standard applicable in a section 363 review, the Bankruptcy Court should consider the increase in value of the SIPA Claim and invalidate the trade. Specifically, the Second Circuit stated that nothing in the case law or the language of section 363 limits the bankruptcy court's review to the date of the signing of the trade confirmation, and that the court (i) is to consider 'all salient factors', which include 'whether the asset is increasing or decreasing in value', and (ii) has flexibility to enhance value of the bankruptcy estate, consistent with its responsibility to secure the best possible bid for the benefit of creditors.[17]

On 10 October 2014, Farnum filed a petition in the Second Circuit for rehearing *en banc*, asserting that (a) the SIPA Claim is located in the BVI, and (b) the Second Circuit decision conflicts with comity and imposes significant burdens on cross-border proceedings.[18] On 13 January 2015, the Second Circuit denied the petition for rehearing *en banc*.

As of this date, the Bankruptcy Court has yet to issue a decision regarding its section 363 review of the SIPA Claim sale.

Conclusion

The Second Circuit *Fairfield* decision clarified the limits of comity: when the Bankruptcy Code requires the bankruptcy court to act with respect to foreign debtors' property located within the US, comity will not override the bankruptcy court's duty. The result is seemingly harsh, especially in cases where a foreign court would require deference from the US bankruptcy court. However, chapter 15 comes with both benefits and requirements. Accordingly, whenever a foreign debtor transfers property located within the territorial jurisdiction of the US (or when the location of property, especially if intangible, is uncertain), it should be expected that the transaction will be subject to section 363 review by the US bankruptcy court. While the outcome may be different outside the Second Circuit, cautious purchasers of a foreign debtor's assets may condition any such transaction upon prompt US bankruptcy court approval to minimise any uncertainty regarding the validity of the transaction.

Notes

13 *In re Fairfield Sentry Ltd.*, 484 B.R. at 625.
14 11 U.S.C. § 1502(8).
15 *In re Fairfield Sentry Ltd.*, 768 F.3d at 244-45.
16 *In re Fairfield Sentry Ltd.*, 768 F.3d at 246.
17 *In re Fairfield Sentry Ltd.*, 768 F.3d at 246-47 (internal quotations omitted).
18 Brief for Rehearing of Appellee at 16–17, *In re Fairfield Sentry Ltd.*, No. 13-3000-bk (2d Cir. 2014) [ECF No. 96].

Apcoa Parking Holdings GmbH & Ors [2014] EWHC 3849 (Ch)

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Introduction

An important decision on a cross border restructuring, *Apcoa Parking Holdings GmbH & Ors* [2014] EWHC 3849 (Ch) is notable for there being opposition to proposed schemes of arrangement at both the convening and sanction hearings. In the face of such opposition, the Court had to look in some detail at certain aspects of the proposed schemes, exploring some of the boundaries of the court's jurisdiction to sanction schemes of arrangement in the process.

The Apcoa group is a leading car park operator, with operations across Europe and this was not the first time the group had utilised schemes of arrangement. Earlier in 2014, in *Apcoa Parking Holdings GmbH & Ors* [2014] EWCH 997 (Ch), the court sanctioned schemes of arrangement in respect of nine Apcoa group companies, with schemes of arrangement being used on that occasion to extend the maturity of senior facilities, without the need to obtain the unanimous consent of lenders. Seven of the nine companies were not incorporated in England and did not have their centre of main interests in the jurisdiction. That being the case, the first Apcoa judgment is in itself interesting in that, in order to establish a sufficient connection with England to found the court's jurisdiction to sanction a scheme, governing law and jurisdiction clauses were amended to refer to English law and the English courts. The court accepted this constituted a sufficient connection, though, on that occasion, the schemes were not opposed.

The original schemes of arrangement having been sanctioned, the Apcoa group companies endeavoured to agree a debt restructuring with its lenders. As it proved impossible to obtain the consent of all lenders, however, the group again sought to put schemes of arrangement in place.

Opposing and supporting parties

As noted above, the schemes were opposed throughout by certain creditors of the group companies, principally FMS WertmanagmentAnstalt öffentlichen Rechts ('FMS'), operating under the supervision and control of an agency of the German Government. Centerbridge Partners ('Centerbridge'), the largest creditor of the Apcoa group, also appeared at both stages of the court process in support of the schemes.

Hildyard J notes (at [22]) that FMS depicted Centerbridge throughout the proceedings as a 'loan to own vulture' who in fact were masterminding the process of the schemes in pursuit of its own commercial objectives. He likewise observed that Centerbridge sought to portray FMS as a 'hold-out creditor', relying on FMS' own website descriptions of itself as an expert on accelerating the unwinding of portfolios, particularly where a borrower is under pressure.

In his judgment, Hildyard J states (at [25]) that neither contestant probably had an interest in the long-term investment in the Apcoa group and that it is instructive to note that class issues needed to be objectively tested by reference to legal rights and legitimate interests. We consider the key aspects of Hildyard J's decision in the case below.

The court's role

Hildyard J's judgment covers his decisions at both the convening and sanction hearings.

At the convening hearing Hildyard J explained (at [42]):

> 'The principal jurisdiction question at the Convening Hearing is normally the identification of the appropriate classes for the purpose of convening meetings to vote upon the scheme proposals; but other matters going to the jurisdiction of the court may also be raised, and it is obviously optimal that any such matters be adjudicated, if possible, since if the court lacks jurisdiction there is no point in any class meetings at all.'

The principles the court must apply when considering whether to sanction a scheme of arrangement are well established and, in this regard, Hildyard J referred to a frequently cited passage from Buckley on the Companies Acts, approved by Plowman J in *Re National Bank Ltd* [1966] 1 WLR 819, 829:

> 'In exercising its power of sanction the court will see, first, that the provisions of the statute have been complied with, second, that the class was fairly represented by those who attended the meeting and that

the statutory majority were acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent and thirdly, that the arrangement is such as an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve. The court does not sit merely to see that the majority are acting bona fide and thereupon to register the decision of the meeting, but, at the same time, the court will be slow to differ from the meeting, unless either the class has not been properly consulted, or the meeting has not considered the matter with a view to the interests of the class which it is empowered to bind, or some blot is found in the scheme.'

Sufficient connection to the jurisdiction

The English courts will only sanction a scheme of arrangement proposed by a foreign company if there is a sufficient connection to England. As demonstrated by *Rodenstock GmbH* [2011] EWHC 1104, a sufficient connection can exist where the rights of scheme creditors are governed by English law and they have submitted to the jurisdiction of the English courts.

As noted above, in this case governing law and jurisdiction clauses were amended to refer to English law and the English courts (having previously referred to German law and the courts of Frankfurt), such amendments only requiring the consent of lenders representing two thirds of the principal amount of the debt. In the earlier Apcoa case, the court held that this constituted a sufficient connection between the scheme companies and England for the English court to have jurisdiction. In the more recent case, the court reached the same conclusion, for the same reasons, notwithstanding FMS' argument that the court did not have jurisdiction to sanction the schemes. The Judge noted, in particular, in this regard that such amendments were permitted and, indeed, there was evidence that the amendments were effective as a matter of German law. Further, the purpose of the amendments had been explained at the time creditor consent was sought and no creditors had sought to challenge the amendments.

Class issues

The test for identifying classes is well established, Hildyard J on this point citing J (at [47]) Chadwick LJ's statement in *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241 that a class 'must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest', going on to explain the starting point is to identify the differences in legal rights as against the company, not interests, and then to determine whether, if there are differences in rights, they are such as to make impossible sensible discussion with a view to the common interest of all concerned (citing *Re Telewest Communications Plc (No 1)* [2005] 1 BCLC 752 at [19] in this regard).

Back in 2013 Apcoa had liquidity issues, but could not obtain the unanimous consent required in order to put in place a new super-senior facility. Apcoa therefore instead entered into a new unsecured facility, with certain senior lenders agreeing to turn over certain recoveries under the senior facilities to the new lenders. At the convening hearing FMS argued that those who had taken part in the turnover agreement should be in a different class to those who had not done so. Hildyard J, however, disagreed; the turnover arrangement did not substantively change the rights of the lenders who had taken part in that arrangement as against the Apcoa companies themselves. Moreover, in any event, any value that might pass under the turnover arrangement was insignificant compared with the senior and subordinated facilities, such that the creditors could, he held, 'unite in a common cause' (at [117]).

New obligations

The proposed schemes of arrangement involved a change in the bank issuing a guarantee facility, with provisions for the new bank to be indemnified by the lenders that participated in the original guarantee facility. FMS objected to such new obligations being imposed. Ultimately it was not, however, necessary for the Judge to decide this issue as the schemes were amended such the taking on of the new obligations was not mandatory.

It is worth noting for future cases though that the Judge did express concerns in this regard, commenting (at [164]) that the imposition of a new obligation to third parties is 'very different from the release in whole or in part of an obligation to such third parties.' He went on to say that, more generally, he was not persuaded that obligations may be imposed under a scheme of arrangement as the jurisdiction insofar as creditors' schemes are concerned appears likely to exist for the purpose of varying the rights of creditors in their capacity as such, rather than imposing new obligations on creditors. He was, however, careful to note (at [167]) that he did not wish to cast doubt on mere extensions or the rolling over of existing facilities involving no new contract or more extensive obligations, such as may be the case in a revolving credit facility.

Class manipulation

FMS submitted that, by terminating the original turnover agreement and entering into a new turnover agreement without binding the Apcoa companies

(thereby robbing the new agreement of any real meaning), the parties to the new turnover agreement were cynically manipulating the classes to force FMS and other dissenting creditors to vote in the same class. FMS pleaded that this amounted to a licence to cram down dissenters.

Hildyard J accepted generally that the court needed to be alive to the prospect of class manipulation in order to avoid gerrymandering, but considered that the authorities which were cited in relation to this issue were off-point. He considered that the answer to the issue had already been addressed in his judgment on the class composition issues (as summarised above).

Non-representative vote

Hildyard J turned next to the issue of whether the approval of the schemes at the class meetings amounted to a reliable indication of commercial soundness. He identified and dealt with three principal requirements of which the first, that the provisions of the relevant statute have been complied with and the requisite majorities achieved, he deemed satisfied.

In relation to the second requirement, that each class was fairly represented at the meeting and that the minority was not coerced by a majority to advance their own interests, the judge observed that the meetings were held on a 100% turnout and that the majorities in favour of the proposals were substantial (86.9 – 97.3%), He added that each member of each relevant class is treated under the schemes in exactly the same way as every other member of that relevant class, with identical rights against the scheme companies both pre and post scheme. Furthermore he stated that sophisticated commercial parties present and voting are recognised by the courts to be in the best position to assess the commercial merits of the scheme.

FMS contended that the economic position of the consenting lenders (in having effectively subordinated their rights under a lockup agreement) was so different from the dissenters (who had not so divested themselves of their rights) as to fail to represent the true interests of the class as a whole and should not therefore be binding on the class. This could be seen as an alternative to the class composition argument and Hildyard J dismissed it in much the same way, noting the similarity of interests of both consenters and dissenters in avoid the Apcoa group's insolvency and the comparatively minor value of the turnover obligations on which FMS exclusively focussed.

The third requirement, 'that the arrangement is such as an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve' prompted Hildyard J to hold that all scheme creditors were experienced commercial parties and there was credible evidence that they had acted in a rational and reasonable manner, as would an honest intelligent member of the classes. He noted that the consenting lenders, who had effectively subordinated themselves, had done so to secure new monies urgently required by Apoca in November 2013. This position was in contrast to that of FMS, who, whilst maintaining that the threat of insolvency was contrived, refused to share the burden of further advances of money, whilst benefitting from the avoidance of insolvency.

Hildyard J observed that FMS' primary motivation for refusing to facilitate the injection of new money was disapproval of Centerbridge's 'loan to own' strategy and added that, it was difficult not to conclude that FMS had sought to use the circumstances as leverage to seek unequal treatment of its own debt. Such a result would have been obviously unfair in favour of FMS.

German law intercreditor agreement

As part of the restructuring proposals relating to the new facility, the existing German law intercreditor-agreement ('ICA') was due to be terminated and replaced by a new English law inter-creditor agreement with new priorities set out therein. FMS submitted that the schemes should not be sanctioned as the release of security envisaged would result in a breach of German law. Expert evidence was adduced to show that:

FMS submitted the following points of German law to support this argument:

1. As a matter of construction, the obligations of the ICA would continue, even after discharge;
2. The ICA (or the existing senior facility agreement ('SFA'), or a combination) created a civil law partnership (*Gesellschaft bürgerlichen Rechts* – 'GBR') between all existing senior facility lenders;
3. A GBR if in existence would create a conflict for SFA lenders who were also new facility agreement lenders who would be unable to vote on the proposals;
4. Purported instruction to release security under the schemes would not be recognised by the German court.

Hildyard J also heard expert evidence on the point from the scheme companies, who contested each of these four contentions. It was common ground that the English court did not need to finally determine the question of German law in order to sanction the schemes, but Hildyard J was clear that he needed to satisfy himself that such sanction would not constitute or necessarily result in a breach of German law.

The judge found that, as with English law, under German law the intentions of the parties would be examined. He found that there was insufficient evidence that the ICA would be of relevance of the release of

security and that, this point aside: (i) there was no real evidence that a GBR was intended by the parties or that one should be imposed unless expressly excluded; (ii) it is the SFA rather than the ICA which governs the relevant relationships regarding security and the SFA's governing law was agreed to have been changed to English law; and (iii) he was persuaded that the relevant provisions of German law in relation to recognition of the schemes would not be engaged.

He concluded that he was satisfied that the German law arguments of FMS did not provide a sufficient basis to prevent the sanction of the schemes.

Recognition and enforcement

As is always the case in the context of a cross border scheme of arrangement, Hildyard J needed to consider issues of recognition and enforcement, but he could see no reason to doubt that the scheme would be recognised and enforced in the relevant EU jurisdictions and that the court, in sanctioning the proposed schemes, would not be acting in vain. Relevant foreign law experts had concluded that the local court in the applicable jurisdiction would recognise and give effect to the schemes.

Conclusion

In view of his conclusions on all the issues discussed above, Hildyard J sanctioned the Apcoa schemes of arrangement.

The impact of the case, however, extends far beyond Apcoa's creditors. The case, being heavily contested, has given the court the opportunity to explore the boundaries of its jurisdiction to sanction schemes of arrangement. Though a flexible way of achieving restructurings, schemes plainly have limits and this case addresses important issues in that regard and as such will be relevant to both cross border and domestic future schemes of arrangement.

Is It Time to Reform Chapter 11 of the US Bankruptcy Code?[1]

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On 8 December 2014, the Commission to Study the Reform of Chapter 11 of the American Bankruptcy Institute (the 'Commission') issued its much-anticipated 400-page Final Report and Recommendations,[2] which sets forth the Commission's recommendations for the reform of chapter 11 of the Bankruptcy Code. While the United States Congress has not begun any formal process to reform the Bankruptcy Code, the Report will undoubtedly influence any upcoming chapter 11 amendment.

I. Background

Since the 19th century, US corporate reorganization laws have been amended approximately every 40 years. The current Bankruptcy Code was enacted in 1978. As it nears its 40th birthday, the Commission found that an evaluation and review of the Bankruptcy Code was appropriate in light of 'the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code'.[3] Indeed, today's financial markets, credit and derivative products, and corporate structures are far different and more complex from those that existed when the Bankruptcy Code was enacted. In addition, it is believed by some that chapter 11 has become too expensive, especially for small and medium-sized companies, which hindered its ability to help rehabilitate certain viable companies.

When the Commission started meeting in January 2012, it embarked on a mission to study chapter 11 and propose reforms that 'will better balance the goals of effectuating the effective reorganization of business debtors – with the attendant preservation and expansion of jobs – and the maximization and realization of asset values for all creditors and stakeholders.'[4] The comprehensive three-year study of chapter 11 involved more than 250 esteemed reorganisation professionals.

The Commission's recommended principles seek to, among other things:[5]

- Reduce barriers to entry by providing debtors more flexibility in arranging debtor in possession financing, clarifying lenders' rights, disclosing additional information about the debtor to stakeholders, and providing a true breathing spell at the beginning of the case during which the debtor and its stakeholders can assess the situation and restructuring alternatives;
- Facilitate more timely and efficient diligence, investigation, and resolution of disputed matters through a neutral party – in a role that would replace the role of an examiner, an individual could be appointed depending on the particular needs of the debtor or its stakeholders to assist with certain aspects of the chapter 11 case;
- Enhance the debtor's restructuring options by simplifying the process of cram down of a chapter 11 plan and by formalizing an express mechanism to permit the sale of all or substantially all of the debtor's assets outside the plan process, while strengthening the protection of creditors' rights in such situations; and
- Incorporate checks and balances on the rights and remedies of the debtor and creditors, including through valuation concepts that may enhance a debtor's liquidity during the case, permit secured creditors to realise the reorganisation value of their collateral at the end of the case, and provide value allocation to junior creditors when supported by the reorganisation value.

Notes

1 The views expressed herein are solely those of Mr Abelson and Ms Zerjal, and not necessarily the views of Proskauer Rose LLP or any of its attorneys. This article provides a summary of only certain recommendations included by the Report (as defined below) and does not purport to comprehensively address all areas or details included in the Report.

2 *Am. Bankr. Inst. Comm'n to Study Reform of Chapter 11, Final Report and Recommendations* 6 (2014), hereinafter, the 'Report'.

3 Report at 3.

4 *Id.*

5 *See* Report at 6.

II. Selected recommendations

Valuation of a Secured Creditor's Collateral.[6] The Report sets forth rules for valuing secured creditors' collateral for different purposes in chapter 11:[7]

- The amount of adequate protection required under section 361 of the Bankruptcy Code to protect a secured creditor's interest in the debtor's property during the chapter 11 case should be determined based on the foreclosure value of the secured creditor's collateral, which is 'the net value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor's collateral under applicable nonbankruptcy law',[8] determined at the time of the request for, or agreement by the parties to provide, adequate protection.
    - The court, however, could consider evidence that the net cash value a secured creditor would realise upon a hypothetical sale of the secured creditor's collateral under section 363 exceeds the collateral's foreclosure value.
- In the event of a sale of collateral, the secured creditor shall be entitled to the value actually realised from the sale of its collateral.
- In the case of a chapter 11 plan contemplating a reorganisation of the debtor, the secured creditor's allowed secured claim should be determined by the 'reorganization value of its collateral,'[9] which is, essentially, (i) the actual sale price in the context of a sale of all or substantially all assets, and (ii) the enterprise value of the reorganised entity.

Cash Collateral and Debtor in Possession Financing ('DIP Financing').[10] The Report's recommendations seek to reduce the lenders' leverage with respect to DIP Financing and the overall course of the chapter 11 cases with the following recommendations.

- **Roll-Up Limitations.** Sometimes, DIP Financing is provided by existing lenders that use the DIP Financing facility to 'roll up' their prepetition debt into the DIP Financing facility or pay their prepetition debt with its proceeds, which affords prepetition lenders significant leverage. The Report's recommendation limits roll-ups to situations in which (i) the post-petition facility is either (a) provided by a new lender, or (b) repays the prepetition facility in cash, extends substantial new credit to the debtor and provides more financing on better terms than alternative facilities offered to the debtor; and (ii) the court finds that the proposed post-petition financing is in the best interests of the estate.
- **Intercreditor Agreements.** Intercreditor agreements commonly include a provision that precludes a prepetition junior secured lender from offering postpetition financing to the debtor without the consent of the senior secured lender. The Commission recommended that junior creditors subject to such prohibition be nonetheless allowed to provide postpetition financing if the proposed facility does not prime the liens of the prepetition senior secured lender. If the court approves the junior lender's postpetition facility, the prepetition senior secured lender must be afforded the right to step in and provide postpetition financing to the debtor on the same terms and subject to the same conditions in lieu of the junior lender.
- **Limitation on Milestones.** The Report recommends that a court not approve any postpetition financing that contains such terms that require the debtor to satisfy certain criteria (e.g., obtain certain orders or file a chapter 11 plan) within the first 60 days of the case. In addition, milestones (and some other extraordinary financing provisions like representations regarding creditor's liens) can only be approved in final orders and cannot be approved on an interim basis.
- **No Liens on Avoidance Actions; Cross-Collateralisation Can Be Used as Adequate Protection.** The Report recommends that debtors should be permitted to use cross-collateralisation to provide adequate protection, but should not be permitted to grant liens on chapter 5 avoidance actions or their proceeds,[11] which is allowed under current practice.
- **Limitation on Sections 506(c) and 552(b) Waivers.** Bankruptcy Code section 506(c) provides for the debtor's rights to recover the costs and expenses

Notes

6 The Report also recommends that a debtor compile a 'valuation information package' ('VIP'), which would include (i) tax returns for the three years prior to the bankruptcy filing, (ii) annual financial statements for the prior three years, (iii) most recent independent appraisals of any of the debtor's material assets, and (iv) all business plans or projections prepared within the past two years (to the extent shared with prepetition creditors and existing or potential purchasers, investors, or lenders). *See* Report, Section IV.A.6, p. 45 *et seq.*

7 *See* Report, Section IV.B.1, p. 67 *et seq.*

8 Report, p. 67.

9 *Id.*

10 *See* Report, Section IV.B, p. 67 *et seq.*

11 The exception is when adequate protection granted to a secured creditor is determined to be insufficient, such secured creditor should be allowed to receive recoveries from avoidance actions through the super-priority claim provided by section 507(b) of the Bankruptcy Code.

of maintaining secured creditors' collateral from secured creditors. Bankruptcy Code section 552(b) allows an 'equities of the case' exception to the extension of prepetition liens on postpetition property. Under current law and practice, debtors' rights under section 506(c) and 552(b) are often waived in favour of secured lenders in connection with DIP Financing or adequate protection requests. The Commission recommends that the debtor be precluded from waiving these rights to preserve potentially valuable claims.

Credit Bidding.[12] Recently, the court in *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014), appeal denied, 2014 WL 576370 (D. Del. Feb. 12, 2014) limited the secured creditor's right to credit bid due to its overly aggressive 'loan-to-own' strategy that chilled competitive bidding.[13] The Commission rejects this approach and proposes that a secured creditor be allowed to credit bid up to the full face amount of its claim when its collateral is sold, and the potential chilling effect of such bid would not constitute 'cause' that allows the court to limit credit bidding.

Asset Sales.[14] The Report recommends two different standards of review for sales out of the ordinary course of business for (i) all or substantially all of the debtor's assets (referred to as a '363x sale'), and (ii) other sales not involving all or substantially all assets. With respect to the latter, the Report suggests a lower standard of review in which the court should find that the debtor has exercised reasonable business judgment. With respect to sales of all or substantially all of the debtor's assets, the Report suggests that they should not occur sooner than 60 days after the petition date unless there is a high likelihood of significant loss of value, and should be reviewed pursuant to standards similar to those required for plan confirmation in Bankruptcy Code section 1129.

Modifications to the Absolute Priority Rule.[15] Sometimes, the estate is valued during an economic downturn, which may unfairly prejudice certain junior creditor classes that could share in distributions if valuation were completed at a different time. The Report includes a Redemption Option Value proposal, pursuant to which the class of creditors immediately junior to the last class receiving distributions would be entitled to receive the value of a hypothetical option to purchase the entire firm at a future date at a price equal to the full entitlement of the senior classes. The Report also recommends codifying 'new value plans', which allow existing equity holders to participate in a reorganisation if they provide economic value to the restructuring effort, even when more senior classes are not paid in full. While certain courts recognise this exception to the absolute priority rule, courts have not adopted a uniform approach. The Report's proposal would permit a prepetition shareholder to retain or purchase an interest in the reorganised debtor without violating the absolute priority rule if (i) contributing new money or money's worth, in an amount proportionate to the equity received or retained by the shareholder, and (ii) such contribution meets a 'reasonable' market test.

Cramdown Interest Rate.[16] The recent decision in *In re MPM Silicones, LLC (In re Momentive)*, No. 14-22503-rdd, 2014 Bankr. LEXIS 3926 (Bankr. S.D.N.Y. Sept. 9, 2014), which followed *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), sparked a heated debate over the appropriate discount rate used to calculate the present value for 'takeback' notes providing deferred payment to creditors. The Report rejects *Momentive*'s risk-free rate and suggests a market-based rate of interest, or, when a market rate is not available, a risk-adjusted rate.

New Numerosity Concept.[17] The Report introduces a 'one creditor, one vote' concept. Currently, for a class to accept a chapter 11 plan, the Bankruptcy Code section 1126(c) requires holders that hold at least two-thirds in amount and one-half in number of allowed claims of a class vote to accept a plan. The Report introduces a 'one creditor, one vote' concept by requiring more than one-half in number of the creditors instead of claims to satisfy the numerosity requirement. This rule would limit strategic acquisitions by affiliates for voting purposes by requiring affiliated entities under common investment management to be treated as a single creditor for voting purposes.

Cramdown Without an Accepting Impaired Class.[18] The Report suggest the elimination of section 1129(a)(10), which requires acceptance of a plan by at least one impaired class of claims, because such provision is often manipulated, including by artificially creating an impaired class to satisfy the requirement.

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12 *See* Report, Section V.B.4, p. 146 *et seq.*
13 *See* Phil Abelson and Maja Zerjal, 'Recent Delaware Bankruptcy Court Decision Limits Secured Claimholder's Right to Credit Bid: The *Fisker* Decision and its Implications' (2014) 11 *International Corporate Rescue* 184.
14 *See* Report, Section IV.C.2, p. 83 *et seq.*; Section V.B.1, p. 135 *et seq.*; Section VI.B, p. 201 *et seq.*
15 *See* Report, Section VI.C, p. 207 *et seq.*; Section VI.C.2, p. 224 *et seq.*
16 *See* Report, Section VI.C.5, p. 234 *et seq.*
17 *See* Report, Section VI.F, p. 257 *et seq.*
18 *See* Report, Section VI.F, p. 257 *et seq.*

Limits on Gifting.[19] In-the-money senior creditors sometimes settle claims of junior classes by providing a 'gift' in the form of recovery to the junior class, even if classes in between are not paid in full. The Report recommends disallowing such 'gifts' because they appear to support undue influence and self-dealing by senior creditors.

Estate Neutral.[20] The Report introduces the 'estate neutral,' a disinterested party that would replace the role of the examiner. By contrast to the appointment of an examiner, which is generally mandatory upon request, the appointment of the estate neutral would be discretionary upon request of the US Trustee or a party in interest, if such appointment would be in the best interests of the estate. The estate neutral's role would be to provide an independent and neutral perspective on selected aspects of a chapter 11 case, but it would be precluded from performing certain functions, including proposing a chapter 11 plan.

Cross-Border Issues.[21] While the Commission did not find chapter 15 issues to be specifically within its mission, it recognised the important interplay between chapter 11 and chapter 15 for multinational debtors. The Commission reviewed certain issues arising in chapter 15 cases. For example, the Commission would limit the trustee's ability to pursue foreign subsequent transferees under section 550 of the Bankruptcy Code due to comity concerns. In addition, the Commission recommends changes to the Bankruptcy Rules that would affect chapter 15 in the following three ways: (i) remove the chapter 15-related provisions from Bankruptcy Rules 1010 and 1011; (ii) create a new Bankruptcy Rule 1012 to govern responses to a chapter 15 petition; and (iii) augment Bankruptcy Rule 2002 to clarify the procedures for giving notice in cross-border proceedings.

Conclusion

At this point, it is unclear whether – and when – the United States Congress may consider a reform of chapter 11, and whether the Report would be closely followed. Given the comprehensive nature of the report and the involvement of some of the most prominent insolvency practitioners and academics in the US, it is likely that the recommendations included in the Report will be influential in any upcoming chapter 11 reform.

Notes

19 *See* Report, Section VI.C.6, p. 237 *et seq.*
20 *See* Report, Section IV.A.3, p. 32 *et seq.*
21 *See* Report, Section IX.E, p. 326 *et seq.*

An Order Denying Confirmation of a Plan in Chapter 13 is not an Immediately Appealable 'Final' Order

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In the United States, district courts have jurisdiction to hear appeals in bankruptcy actions from (i) 'final judgments, orders, and decrees', (ii) 'interlocutory orders and decrees' issued under Bankruptcy Code section 1121(d) that increase or reduce the debtor's exclusive period to file a plan; and (ii) other interlocutory orders and decrees *with leave of the court*.[2] In other words, if an order is 'final', it can be immediately appealed, but if it is interlocutory (i.e., not final), the appellant must first obtain leave of the court. The ability to seek immediate appellate review is often essential – but when is an order 'final'? In the bankruptcy context, 'final' is not the same as in ordinary civil litigation, because a bankruptcy case involves 'an aggregation of individual controversies', many of which would be stand-alone lawsuits but for the bankruptcy case.[3] The test is more flexible, and generally allows an order to be final when it definitely resolves a discrete dispute within a larger case.[4]

Flexibility, however, sometimes results in uncertainty as to whether an order will be deemed final or interlocutory. For example, while it is generally understood an order confirming a plan of reorganisation is final, circuit courts disagreed as to whether an order denying confirmation of a repayment plan under chapter 13 of the Bankruptcy Code was final or interlocutory.[5] On 4 May 2015, the Supreme Court of the United States (the 'Supreme Court') sided with the majority in the circuit split and held that an order denying confirmation of a repayment plan pursuant to a chapter 13 bankruptcy case is not a final order that the debtor can immediately appeal.[6] The decision is silent as to whether it applies to corporate reorganisations in chapter 11 of the Bankruptcy Code, but it may well be influential with respect to the finality of such orders in chapter 11.

Background

Petitioner Louis Bullard filed a petition under chapter 13 of the Bankruptcy Code, which enables individuals with regular income streams[7] to obtain some debt relief through a repayment plan while remaining in possession of their property.[8] Under a repayment plan confirmed by the bankruptcy court, debtors repay (usually a part of) their debt from their future income within three to five years, and are discharged from the residual debt thereafter if they successfully carry out the plan.[9]

Bullard's largest creditor was Blue Hills Bank (the 'Bank'), which held a mortgage on a multifamily house Bullard owned.[10] The mortgage was 'underwater:' the house was worth much less than the USD 346,000 Bullard owed the Bank.[11] After two pre-confirmation modifications to the plan, Bullard proffered a 'hybrid

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 28 U.S.C. § 158(a)(1)-(3).
3 *Bullard v Blue Hills Bank*, 135 S. Ct. 1686, 1690 (2015), citing 1 Collier on Bankruptcy ¶5.08[1][b], p. 5-42 (16th ed. 2014).
4 *See, e.g., Howard Delivery Service, Inc. v Zurich American Ins. Co.*, 547 U. S. 651, 657, n. 3, (2006); *Zedan v Habash*, 529 F.3d 398, 402 (7th Cir. 2008); *In re Rimsat, Ltd.*, 212 F.3d 1039, 1044 (7th Cir. 2000) ('[F]inality does not require a final order concluding the entire bankruptcy proceeding; certain orders entered prior to the conclusion of the bankruptcy proceeding will be deemed final.'); *see also In re Saco Local Dev. Corp.*, 711 F.2d 441 (1st Cir. 1983).
5 The majority view – adopted by the First, Second, Eighth, Ninth, and Tenth Circuits – advocated non-finality, while the minority view – adopted by the Fourth, Third, and Fifth Circuits – held to the contrary and allowed an order denying confirmation to be immediately appealable. *See In re Bullard*, 752 F.3d 483, 486 (1st Cir.) *cert. granted sub nom. Bullard v Hyde Park Sav. Bank*, 135 S. Ct. 781, 190 L. Ed. 2d 649 (2014) *and aff'd sub nom. Bullard v Blue Hills Bank*, 135 S. Ct. 1686 (2015) (discussing the circuit split).
6 *Bullard v Blue Hills Bank*, 135 S. Ct. at 1690.
7 Only individuals with regular income that owe, on the petition date, unsecured debts of less than USD 383,175 and secured debts of less than USD 1,149,525 are eligible for relief under chapter 13. 11 U.S.C. 109(e).
8 By contrast, in a chapter 7 case, non-exempt assets are usually sold to distribute proceeds to creditors.
9 *Bullard*, 135 S. Ct. at 1690.
10 *Id.*
11 *Id.*

treatment of his debt' through a plan which split the debt into a secured claim for the then-current value of the house (USD 245,000), and an unsecured claim for the remainder (USD 101,000).[12] The payment plan consisted of regular mortgage payments directed at the secured claim, which would eventually be paid in full, but long after the conclusion of the bankruptcy case.[13] The unsecured claim, on the other hand, would only be paid 'as his income would allow' over the five years post-confirmation, and the balance remaining after the five-year period would be discharged.[14] Pursuant to this plan, only USD 5,000 of the USD 101,000 in unsecured debt would be repaid.

The Bank objected to the plan and the bankruptcy court declined to confirm it,[15] finding that chapter 13 did not allow confirmation of a plan that did not contemplate paying the secured portion within the plan period, even though the bankruptcy court acknowledged other bankruptcy courts in the First Circuit had approved such arrangements.[16] The bankruptcy court ordered Bullard to submit a new plan within 30 days.[17]

Bullard appealed the denial of his repayment plan to the Bankruptcy Appellate Panel ('BAP') of the First Circuit. The BAP noted that an order denying plan confirmation was not final because Bullard was 'free to propose an alternate plan'.[18] The court nevertheless granted leave to hear the appeal as interlocutory, because the dispute concerned a 'controlling question of law' involving a considerable 'ground for difference of opinion'.[19] The BAP agreed with the bankruptcy court that Bullard's proposed treatment of the Bank's claim was not allowed.[20]

Bullard then appealed to the Court of Appeals for the First Circuit ('First Circuit'), which dismissed the case for lack of jurisdiction.[21] Discussing the issue of finality, the First Circuit found that there is no finality in a BAP order 'unless the underlying bankruptcy court order is final' – which, in the First Circuit's view, the bankruptcy court's order was not.[22]

The Supreme Court of the United States granted certiorari on 12 December 2014.[23] The question presented was whether 'an order denying confirmation [of a repayment plan pursuant to a chapter 13 bankruptcy case] is a "final" order that the debtor can immediately appeal'.[24] The Supreme Court held that it is not.[25]

Supreme Court decision

Immediately appealable proceeding: plan-by-plan approach vs. entire consideration process

Bullard proposed a 'plan-by-plan' answer for the question of what the proper definition of an appealable proceeding is in a situation that involves a chapter 13 plan.[26] According to Bullard, each plan review is a discrete proceeding and therefore both 'an order denying confirmation and an order granting confirmation' terminate the proceeding, allowing for immediate appeal.[27]

In response, the Bank argued that the proceeding involves the entire plan consideration process, which terminates only at plan confirmation or, if the debtor fails to offer a confirmable plan, case dismissal.[28] Direct appeal is not available after plan rejection 'so long as it leaves the debtor free to propose another plan'.[29]

Chief Justice Roberts, writing for the Supreme Court, agreed with the Bank that the 'relevant proceeding is the process of attempting to arrive at an approved plan that would allow the bankruptcy to move forward'.[30] The Supreme Court emphasised the preclusive effect of plan confirmation or case dismissal that is lacking in plan rejection. When a plan is confirmed, the rights and obligations of the parties are fixed, binding debtor and creditors to its terms. When plan confirmation is

Notes

12 *Id.*
13 *Id.* at 1691.
14 *Id.*
15 *In re Bullard*, 475 B.R. 304 (Bank. D. Mass. 2012).
16 *Id.* at 309, 314.
17 *Id.* at 314.
18 *In re Bullard*, 494 B.R. 92, 95 (2013).
19 *Id.* at 95 n. 5.
20 *Id.* at 100.
21 *In re Bullard*, 752 F.3d 483 (2014).
22 *Id.* at 48.
23 *Bullard v Hyde Park Sav. Bank*, 135 S. Ct. 781, 190 L. Ed. 2d 649 (2014)
24 *Bullard*, 135 S. Ct. at 1690.
25 *Id.*
26 *Id.* at 1692.
27 *Id.*
28 *Id.*
29 *Id.*
30 *Id.*

denied and a case is dismissed, consequences are similarly significant because the automatic stay is lifted, and the possibility of a discharge and other benefits fades.[31]

By contrast, the denial of a proposed plan with leave to amend changes little. The critical automatic stay that halts creditors' collection efforts persists, discharge remains a possibility, and the 'rights and obligations remain unsettled'.[32] This is hardly final. The only aspect of plan dismissal that is final is the unavailability of said plan. The Supreme Court compared it to a price offer rejection during the negotiation for the purchase of a new car, which doesn't end the purchase process. In other words, '[i]t ain't over till it's over'.[33]

In the Supreme Court's view, this conclusion is also supported by the text of the Bankruptcy Code. 'Core proceedings' entrusted to bankruptcy judges includes 'confirmation of plans', but does not mention any denial of plans, which suggests the larger confirmation process should be viewed as a 'proceeding'.[34]

The inefficiency of Bullard's approach

Bullard's view promotes piecemeal appellate review because each plan denial provides for an opportunity to appeal. Such an outcome cuts against the concept of finality. Bullard contended that debtors lack means to take on several appeals and would appeal significant rulings only.[35] The Supreme Court, however, warned that the option of immediate appeal is viewed as leverage because of the continued effect of the automatic stay and potentially costly delay for creditors. While carefully avoiding a statement as to whether the same finality rule would apply in a chapter 11 case, the Supreme Court noted that Bullard's approach would be especially concerning in chapter 11 cases, where the debtors, primarily business entities, have the resources to appeal 'narrow issues'.[36]

Not all orders resolving contested matters are final

The Solicitor General, supporting Bullard for the United States as amicus curiae, presented an 'unclear' argument that any order resolving a contested matter is final and, thus, appealable. Bankruptcy disputes are classified as either 'adversary proceedings' or 'contested matters'.[37] According to the Solicitor General, because an objection to a plan initiates a contested matter,[38] and confirmation of that plan resolves that matter and is final, an order that alternatively denies confirmation also resolves that contested matter, and should therefore be considered final.[39]

This argument failed to persuade the Supreme Court for several reasons. First, the scope of the Solicitor General's view was implausible. Finality simply could not reach the 'endless' list of contested matters which includes all types of 'minor disagreements'.[40] Second, the Solicitor General's circular reasoning undermined his alternative argument that 'because one possible resolution of this particular contested matter (confirmation) is final, the other (denial) must be as well'.[41] This 'begs the question' and assumes that since one resolution leads to appeal, all resolutions of that dispute lead to an appeal. Third, Bullard and the Solicitor General raised concerns that unless their rule was adopted, the Supreme Court would create unfair asymmetry between parties by allowing creditors to appeal a grant of plan confirmation while denying debtors that option when confirmation is denied, and forcing them instead to draft a new plan. This, again, is simply a reflection that plan confirmation is preclusive and 'allows the bankruptcy to go forward and alters the legal relationships among the parties', while denial does not.[42] Moreover, this would disadvantage creditors in a situation where there are multiple creditors with opposing positions to a plan.[43] Under those facts, a creditor favouring the plan would be in the same position as Bullard: unable to appeal its preferred plan.

Notes

31 *Id.*
32 *Id.* at 1693.
33 *Id.*
34 *Id.*
35 *Id.*
36 *Id.*
37 *Id.* at 1694. (internal citations omitted).
38 Fed. Rule Bankr. Proc. 3015(f).
39 *Bullard*, 135 S. Ct. at 1694.
40 *Id.*
41 *Id.*
42 *Id.* at 1695.
43 *Id.*

There is always interlocutory review – if the lower courts grant it

The Supreme Court acknowledged Bullard raised one practical objection: the lack of effective means to seek appellate review following a denial order.[44] A debtor must either 'seek or accept dismissal of his case and then appeal,' or 'propose an amended plan and appeal its confirmation'.[45]

The first option would end the automatic stay and put the debtor's property at risk.[46] Even if a bankruptcy court maintains the stay, the debtor is risking it all, property and case, on appeal. The second option is just as poor because an 'acceptable, confirmable alternative may not exist' and even if it does, it may 'have immediate and irreversible effects' that a court is unlikely to stay – and, it is a waste of time and money to force the debtor to propose and seek confirmation of a plan he does not want.[47]

The Supreme Court dismissed these concerns by simply noting that 'imperfect' remedies are part of the litigation system, which can be tolerated because bankruptcy courts supposedly 'rule correctly most of time' – and when not, such mistakes are not 'of a sort that justifies the costs entailed by a system of universal immediate appeals'.[48]

More importantly, parties can always seek interlocutory review of important questions that require immediate consideration.[49] Even though such review is discretionary, the Supreme Court opined that they 'serve as useful safety valves for promptly correcting serious errors and addressing important legal questions'.[50] Bullard opposed this notion because lower courts can be reticent in granting leave to pursue an interlocutory appeal from that same court's orders, but this argument lacked credibility when interlocutory review was granted (by the BAP) in this very case.

Conclusion

The Supreme Court's decision provides a clear rule regarding the finality of orders denying confirmation in chapter 13 cases. The decision seemingly shifts the balance of power to creditors by preventing the debtor from intentionally slowing down the plan process by appealing a denial of a plan, and implicitly forcing the debtor to negotiate the creditors – but, the debtor still retains the exclusive right to propose a plan. By contrast, in chapter 11, the debtors' exclusive right to file a plan expires after a certain period of time. This and other differences between chapter 11 and chapter 13, coupled with the Supreme Court's refusal to apply any of its conclusions to chapter 11 cases, imply it is impossible to know if, and to what extent, the decision will apply to orders denying chapter 11 plans. Based on similar applications of chapter 13 decisions to chapter 11 cases,[51] and the current circuit split on the same issue in chapter 11,[51] it is reasonable to expect the Supreme Court's decision will carry at least some weight in chapter 11 cases.

Notes

44 *Id.*
45 *Id.*
46 *Id.*
47 *Id.*
48 *Bullard*, 135 S. Ct. at 1695.
49 *Id.*
50 *Id.*
51 *See, e.g., In re MPM Silicones, LLC*, No. 14-22503-rdd, 2014 Bankr. LEXIS 3926 (Bankr. S.D.N.Y. Sept. 9, 2014) (in a chapter 11 case, rejecting a market-based approach to calculating the cramdown interest rate and endorsing the formula approach espoused in the chapter 13 cases *Till v SCS Credit Corp.*, 541 U.S. 465 (2004)).
52 There are presently three circuits that hold denial of confirmation of a plan is not a final appealable order. *See In re Civic Partners Sioux City*, 2015 WL 884075 (8th Cir. 2015); *In re Lindsey*, 726 F.3d 857 (6th Cir. 2013); *In re Lievsay*, 118 F.3d 661, 662–63 (9th Cir. 1997). So far, only the Third Circuit permitted an appeal from denial of plan confirmation in the chapter 11 context. *In re Armstrong World Indus.*, 432 F.3d 507, 511 (3d Cir. 2005).

Re Harvest Finance Ltd (in Liquidation); Jackson and another v Cannons Law Practice LLP and others: Time Costs for Performing a Public Duty for an Office Holder Are Unlikely To Be Recoverable

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The liquidators (the 'Liquidators') of Harvest Finance Ltd (in liquidation) (the 'Company') were successful in their application under sections 234 and 236 of the Insolvency Act 1986 (the 'IA 1986') against the respondents, Cannons Law Practice LLP ('Cannons').[1] The court ordered that Cannons deliver the documents and electronic files under their control. The application by Cannons in *Re Harvest Finance Ltd* asked the court to consider whether it had jurisdiction to order the payment of expenses which were incurred by Cannons in complying with the order. The court held that it should not, in this instance, exercise its discretion to allow Cannons to charge for the cost of their compliance with the order of the court.

Background

The company was suspected to have been engaged in international fraud as a vehicle for loans charged on securities at artificially inflated values. Cannons were a firm of solicitors who had acted for many of the special purpose vehicles that were under investigation in connection with the suspected international fraud. The Liquidators made an application under sections 234 and 236 of the IA 1986 for the disclosure and retrieval of various documents in relation to the Company and held under the control of Cannons, to aid their investigation into a significant number of the Company's conveyancing transactions that were suspected to be fraudulent. Although the court found that Cannons had no knowledge of, or participation in, the fraud, the Liquidators believed that Cannons held documents relevant to it.

Cannons were ordered to deliver the documents to the Liquidators as requested (the 'Document Order'). Cannons later sought an application to the court for reimbursement of the costs it incurred as a result of complying with the Document Order. Cannons submitted a claim for costs which amounted to GBP 40,381 excluding VAT.

Issues before the court

Initially the court was concerned with whether any legal privilege attached to the requested files should be overridden. In addition, Cannons' application highlighted two substantive issues for the court, namely:

1. Whether the court had jurisdiction to order payment of Cannons' costs incurred in complying with the Document Order and delivering the requested documents to the Liquidators; and
2. Whether the court should exercise its discretion to order such (or any) payment by the Liquidators of Cannons' compliance costs.

The facts

Cannons initially refused to produce the files in relation to the Company without protective orders from the court on the basis that the contents of the documents in their possession were, or potentially could be, privileged. Compulsory orders were subsequently made under sections 234 and 236 of the IA 1986 following which the dispute surrounding the costs of compliance with such an order (the 'Compliance Costs') arose. Unfortunately there are conflicting High Court authorities on whether the court has jurisdiction to order Compliance Costs following *Re Aveling Barford* [1988] 3 All ER 1019 (judgment of Hoffman J) and *Re Cloverbay* [1989] BCLC 724 (judgment of Vinelott J). In *Re Cloverbay*, the court held that rule 9.6(4) of the Insolvency Rules (as amended) did not provide for payment of the cost of compliance with an order and the court could only order the costs by way of a conditional order. The

Notes

1 *Re Harvest Finance Ltd (in Liquidation); Jackson and another v Cannons Law Practice LLP and others* [2014] EWHC 4237 (Ch), [2014] All ER (D) 216 (Dec).

court held that this should only be done in exceptional circumstances because of the existence of a public duty to assist an office holder. By contrast, in *Re Aveling Barford Ltd*, the court held that 'innocent parties' should be paid the cost of their compliance with a court order.

During discussions between Cannons and the Liquidators, the Liquidators offered to pay Cannons GBP 500 for the reasonable costs of locating and delivering the files to the Liquidators. In contrast, the Liquidators considered Cannons' costs in excess of forty thousand pounds to be wildly disproportionate to the administrative task at hand.

The Liquidators argued that the court lacked the power to award the respondents' compliance costs; whereas the respondents argued that they were an innocent party and ought to be reimbursed.

Under Section 234 of the IA, an office holder is afforded a summary procedure to obtain a company's property or records from third parties, in this case Cannons. Section 236 of the IA 1986 provides office holders with the authority to seek an order from the court enabling them to clarify a company's circumstances and carry out their statutory duties to put the affairs of the insolvent estate in order and identify and recover assets. The office holder is required to investigate the causes of a company's failure and the extent to which any respondent's conduct contributed to it.

The Insolvency Rules (as amended) provide a wide discretion to allow the court jurisdiction to declare the Compliance Costs an expense of the liquidation.[2] However, as an expense of the liquidation they would rank ahead of other expenses, including the remuneration of the Liquidators.

Decision

In considering whether to displace legal privilege, Mr Registrar Jones held that the court should examine if there is evidence which indicates a strong prima facie case for either criminal or fraudulent conduct. In the case of *Re Harvest Finance Ltd*, the total security for the material loans which included security over certain properties (the 'Properties') valued at GBP 161m, whereas the sale of the Properties resulted in a significantly lower realisation of GBP 8m. In such circumstances, Mr Registrar Jones held that strong connotations of fraud displaced any privilege attaching to the documents in Cannons' possession.

Furthermore, Mr Registrar Jones held that Cannons were not permitted to recover their Compliance Costs, despite the fact that they were an innocent party to the proceedings. The Registrar held that although he most likely did have jurisdiction to award costs to Cannons he would not exercise it as:

- Cannons had control over the relevant files and documents and it was in their power alone to produce them to the Liquidators;
- Mr Registrar Jones noted that the requirement of 'a public duty in the administration of justice' exists in order that office holders are assisted in the performance of their statutory duties and to enable an effective insolvency regime within the UK jurisdiction. Accordingly, those with relevant knowledge should assist as a matter of public duty.[3] The element of public duty is particularly important especially given the context of suspicion of fraud;
- an order for the payment of Cannons' Compliance Costs would transform their public duty into a professional service;
- the Registrar stated that '[t]he Liquidation should not have to bear the financial burden resulting from the fact that the records were not easy to access' owing to poor filing on the part of Cannons, which hindered their access to the documents; and
- the difficulties Cannons faced in identifying and retrieving the files were not sufficient to justify the recovery of the Compliance Costs. Furthermore, Cannons should have raised their difficulty in tracing the documents to the attention of the Liquidators before incurring the cost of it.

Conclusion

Re Harvest Finance Limited has reinforced the judgement of *Re Cloverbay*. The courts are usually unwilling to order the costs of complying with a section 234 and 236 orders met by the applicants (in this case, the Liquidators) or paid as an expense of the liquidation. The decision of the court was focussed on the fact that there is a public duty to assist office holders in the exercise of their statutory duties. It seems highly unlikely that such costs in all but limited circumstances will be recoverable from a liquidation. However, it should still be noted that the court may have the jurisdiction to make such a costs order if the circumstances permit and require it.

Practical implications

The case draws out several practical implications for practitioners in this field. Notably, the court has

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2 9.6(4) of section 51 of the Senior Courts Act 1981.

3 *Re John T. Rhodes Ltd* (1986) BCC 99.284 per Harman J., referred to in *Re Cloverbay Limited* [1989] BCLC 724 at page 738.

demonstrated its eagerness to facilitate any investigation which may involve fraudulent and criminal activity to the extent that legal privilege will be readily set aside in either circumstance. The public duty to assist in any such investigation must not be taken lightly as failure to act in accordance with an order to assist an office holder will likely expose that person to adverse costs consequences. It is also clear that if a public duty stems from a liquidator necessarily requiring information to be obtained in order to carry out their statutory duties, then the court has a substantial reason not to award the costs of compliance with such an order.

However, the quantum of any such compliance costs and whether the court has the jurisdiction to award them is likely to be an ongoing area of debate. Despite alluding to the fact that it is likely, Mr Registrar Jones did not reach a firm conclusion on whether the court has jurisdiction to order payment of the respondents' costs incurred in complying with the order made under sections 234 and 236 of the IA 1986.

Therefore office holders should be aware of the potential for the courts to order costs in liquidation when making applications under sections 234 and 236 of the IA 1986. In making any such application, office holders should be ready to provide suitable justification as to why a costs order would be inappropriate in the circumstances.

New York Choice of Law and Forum Selection in an Indenture is 'Property' Making a Debtor Eligible for Relief Under the US Bankruptcy Code[1]

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The United States Bankruptcy Court for the Southern District of New York (the 'Bankruptcy Court') held that the presence of a New York choice of law and forum selection in an indenture satisfied the US Bankruptcy Code eligibility requirement of 'property in the US'.[2] The decision should reassure foreign debtors without another presence in the US that chapter 15 protection is still available in New York and other courts within the Second Circuit, which is, so far, the only Circuit that has restricted a foreign debtor's access to chapter 15 by requiring property in the US.

Background

Berau Capital Resources PTE Ltd. ('Berau'), a Singapore company, was incorporated in 2010 as a special purpose vehicle to raise funds for BCE Group, the fifth largest coal producer in Indonesia. In 2010, Berau entered into an indenture and a supplemental indenture (collectively, 'Indenture'), pursuant to which it issued USD 450 million senior secured notes due in 2015 ('2015 Notes'), which were guaranteed by certain subsidiaries of BCE Group incorporated in various jurisdictions. The Indenture provided for New York choice of law and jurisdiction.

BCE Group's performance deteriorated due to lower coal prices and management disputes. As a result, Berau was unable to pay the USD 450 million principal due under the 2015 Notes. To prevent noteholders from collecting on the notes, Berau commenced proceedings in the High Court of the Republic of Singapore, which imposed a 6-month moratorium on collection activity against Berau and an injunction protecting the guarantors from collection efforts ('Singapore Order'). Berau and noteholders holding a substantial amount under the 2015 Notes then entered into a restructuring support agreement, pursuant to which the supporting noteholders agreed to refrain from taking any unilateral action against any member of the BCE Group and to support its restructuring efforts.

Shortly thereafter, Berau filed a verified petition in the US for recognition of the Singapore proceeding as a foreign main proceeding and sought to extend the automatic stay under the US Bankruptcy Code to protect the guarantors of its obligations. According to Berau, the main reason for filing chapter 15 was to prevent creditors from commencing actions within the US in contravention of the order issued by the Singapore court. Berau argued it would be irreparably harmed if creditors were allowed to commence actions in the US because it would frustrate BCE Group's restructuring efforts and would prevent all claims from being orderly administered in the Singapore proceeding.

The Bankruptcy Court granted provisional relief by enjoining all entities from commencing any action within the US against Berau or the guarantors in contravention of the Singapore Order. At the hearing, the judge noted that the Second Circuit 'has read [the property requirement of Bankruptcy Code section 109] in a particular way' – namely, that a foreign debtor has to have property in the US to be eligible for relief under chapter 15.[3] The only property in the US that Berau identified was an attorney retainer.[4] While the Bankruptcy Court agreed that at least one decision found an attorney retainer to be sufficient to satisfy section

Notes

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

2 *In re Berau Capital Res. PTE Ltd.*, Case No. 15-11804 (MG), 2015 Bankr. LEXIS 3653 (Bankr. S.D.N.Y Oct. 28, 2015).

3 *In re Berau Capital Res. PTE Ltd.*, Case No. 15-11804 (MG), Transcript of Hearing at 21:17-18 (Bankr. S.D.N.Y. Aug. 4, 2015) (hereinafter 'Transcript'); *see Barnet v Fletcher (In re Barnet)*, 737 F.3d 238 (2d Cir. 2013) (finding a foreign debtor must show it has property in the US pursuant to Bankruptcy Code section 109(a) as a condition to obtaining recognition in the US under chapter 15).

4 *Memorandum of Law of Kin Chan, as Foreign Representative of the Above-Captioned Debtor in a Foreign Proceeding, for (i) Recognition of Foreign Main Proceeding, Pursuant to 11 U.S.C. §§ 1515 and 1517, (ii) Relief Pursuant to 11 U.S.C. §§ 1520 and 1521, and (iii) Provisional Relief Pursuant to 11 U.S.C. §§ 105(a) and 1519*, Case No. 15-11804 (MG) (Bankr. S.D.N.Y. Jul. 13, 2015) [ECF No. 9], at ¶ 7.

109(a), it asked the foreign representative to submit a supplemental brief addressing whether contract rights of a foreign debtor under an indenture that includes a New York governing law clause and consent to New York jurisdiction constitutes property in the US.[5]

New York choice of law and forum selection in an indenture are 'property' under the Bankruptcy Code

After the foreign representative submitted the supplemental brief arguing that the Indenture provisions did indeed constitute 'property' under the Bankruptcy Code,[6] the Bankruptcy Court issued an order recognizing Berau's Singapore proceeding as a foreign main proceeding and finding that the section 109(a) requirement was satisfied by both (i) an interest in its US counsel's retainer account, and (ii) intangible contract rights under the Indenture and related agreements, the situs of which intangible contract rights was in New York.[7] The judge remarked that 'it would be ironic if a foreign debtor's creditors could sue to enforce the debt in New York, but in the event of a foreign insolvency proceeding, the foreign representative could not file and obtain protection under chapter 15 from a New York bankruptcy court.'[8] The Bankruptcy Court concluded 'no such conundrum exists' because the Indenture provisions constituted Berau's property in the US in the sense of 'property' under Bankruptcy Code section 109(a).[9]

The Bankruptcy Court found that contract rights are intangible property of the debtor, with the location of such property to be determined under applicable nonbankruptcy law.[10] While intangible rights may have more than one situs, the Bankruptcy Court concluded that the attributes of the Indenture and New York laws established the situs of the Indenture rights in New York. The Bankruptcy Court relied on New York laws that make contracts of substantial size with New York governing law and forum selection enforceable in New York: (i) N.Y. General Obligations Law § 5-1401 (Choice of Law), which provides that the parties to any contract arising out of a transaction covering not less than USD 250,000 may agree that New York law governs; (ii) N.Y. General Obligation Law § 5-1402 (Choice of Forum), which provides that any person may maintain an action in a New York court against a foreign corporation that relates to a contract made in whole or in part pursuant to the previous section and that arises out of a transaction involving not less than USD 1 million; and (iii) CPLR 327(b), which provides that a court may not stay or dismiss an action on grounds of inconvenient forum where the action relates to a contract to which the above sections 5-1401 and 5-1402 apply.[11] The Indenture easily satisfied these requirements, as it governed USD 450 million of debt and provided for New York governing law and New York forum selection.

The Bankruptcy Court's request for additional briefing on the eligibility requirement and memorandum opinion displayed a willingness to 'provide additional support for proceedings – Chapter 15 proceedings in New York whether or not there's an attorney retainer.'[12] The Bankruptcy Court's effort was aimed at the additional property hurdle to recognition imposed in *Barnet v Fletcher (In re Barnet)*, 737 F.3d 238 (2d Cir. 2013).[13] 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.

While *Barnet* remains binding on New York bankruptcy courts, a popular venue for chapter 15 debtors, *Berau* should provide comfort to foreign debtors that the Second Circuit's additional recognition requirement is not an insurmountable obstacle. First, in *Barnet*, the Bankruptcy Court clarified on remand that section 109(a) could be satisfied with (i) claims and causes of action against US entities, and (ii) a retainer held by the foreign debtor's US counsel.[14] Since then, chapter 15 debtors in New York have been able to satisfy the

Notes

5 Transcript at 21:23-22:6.

6 *Supplemental Memorandum Of Law Of Kin Chan, As Foreign Representative Of The Above-Captioned Debtor In A Foreign Proceeding, For (I) Recognition Of Foreign Main Proceeding Pursuant To 11 U.S.C. §§ 1515 And 1517, (II) Relief Pursuant To 11 U.S.C. §§ 1520 And 1521 And (III) Immediate Relief Pursuant To 11 U.S.C. §§ 105(a) And 1519*, Case No. 15-11804 (MG) (Bankr. S.D.N.Y. Aug. 19, 2015) [ECF No. 23].

7 *Order Granting Recognition of Foreign Main Proceeding and Certain Related Relief,* Case No. 15-11804 (MG) (Bankr. S.D.N.Y. Oct. 16, 2015) [ECF No. 32), at § D.

8 *Id.* at *4.

9 *Id.*

10 *Id.* at *5.

11 *Id.*

12 Transcript at 23:1-4. The judge remarked that whether the Indenture's New York choice of law and forum selection clauses satisfied the property requirement is 'an issue likely to recur in other cases'. *In re Berau Capital Res. PTE Ltd.*, Case No. 15-11804 (MG), 2015 Bankr. LEXIS 3653 at *8.

13 Judge Glenn specifically noted *Barnet* 'continues to be a frequent subject of discussion and criticism at international insolvency conferences and in scholarly writing.' *In re Berau Capital Res. PTE Ltd.*, Case No. 15-11804 (MG), 2015 Bankr. LEXIS 3653 at *1.

14 *In re Octaviar Admin. Pty Ltd.*, 511 B.R. 361 (Bankr. S.D.N.Y. 2014).

section 109(a) standard based solely on the retainer their US counsel held.[15] Yet, the reality is that '[f]oreign debtors who wish to file chapter 15 cases in New York often have no place of business in the United States,'[16] and in certain circumstances, even establishing such minimum presence in the US as a retainer account may be too burdensome and may drive foreign debtors to seek chapter 15 relief in a different Circuit.

As Bankruptcy Code section 109(a) applies to debtors under all chapters of the Bankruptcy Code,[17] *Berau*'s holding reaches beyond chapter 15 and further expands the body of law that interprets 'property in the US' under section 109(a) broadly. Indeed, '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'.[18] For example, section 109(a) was satisfied when a debtor held a bank account with USD 194;[19] a bank account with USD 32,000 and ownership of a company in the United States;[20] and a bank account with USD 100, marketing and advertising materials, equipment on a houseboat, and conducted business through offices in the U.S.[21] While section 109(a) does not say anything about the amount of property or the circumstances surrounding the debtor's acquisition of such property,[22] prospective foreign debtors should be mindful that there may be cases in which courts may find ample authority under the Bankruptcy Code to dismiss a case or abstain.[23] Indeed, section 305 provides a court may dismiss a case or suspend all proceedings at any time if a chapter 15 petition for recognition had been granted, and the purpose of chapter 15 would be best served by such dismissal or suspension.[24]

Notes

15 *See, e.g., In re B. Endeavour Shipping Company Limited,* Case No. 15-10246 (REG) (Bankr. S.D.N.Y. Mar. 10, 2015) [ECF No. 10].

16 *In re Berau Capital Res. PTE Ltd.*, Case No. 15-11804 (MG), 2015 Bankr. LEXIS 3653 at *1.

17 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.'

18 *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).

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

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

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

22 *In re Octaviar Admin. Pty Ltd.*, 511 B.R. at 373.

23 *Id.*

24 11 U.S.C. § 305(a)(2). For example, in *In re Ionica plc*, 241 B.R. 829, (Bankr. S.D.N.Y. 1999); *In re Xacur*, 219 B.R. 956 (Bankr. S.D. Tex. 1998); and *In re Cenargo Int'l, plc*, 294 B.R. 571 (Bankr. S.D.N.Y. 2003), courts dismissed US cases commenced under the US Bankruptcy Code in favor of foreign proceedings. In all those cases, 'the existence of a foreign proceeding and the fact that the foreign proceeding was entitled to recognition under § 305(a)(2)(B) were important factors.' *In re Aerovias Nacionales de Colom. S.A. Avianca*, 303 B.R. 1, 11 (Bankr. S.D.N.Y. 2003).

Jetivia SA v Bilta (UK) Limited: The Illegality Defence of *ex turpi causa non oritur actio* and the Extra-territorial Effect of Section 213 Insolvency Act 1986

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On 22 April 2015 the Supreme Court handed down its judgment in *Jetivia SA v Bilta (UK) Limited*, which unanimously held that a company that is the subject of the fraudulent decisions of its directors will not have the fraudulent acts attributed to it so as to afford its directors the defence of illegality.[1] In addition, the court held that the provisions of the Insolvency Act 1986 ('IA 1986') in respect of fraudulent trading are extra-territorial in their effect.

Background

Bilta (UK) Limited ('Bilta') was an English company which entered compulsory liquidation in November 2009. Bilta's board of directors comprised Mr Nazir and Mr Chopra. Mr Chopra was also Bilta's sole shareholder. Together, the directors were accused of causing Bilta to engage in the fraudulent trading of carbon credits with third parties including Jetivia SA ('Jetivia'), a company based in Switzerland.

The trading Bilta engaged in amounted to a 'missing trader' or 'carousel' fraud. Between April and July 2009 Bilta purchased Danish-registered European Emissions Allowances, a type of carbon credit, from Jetivia outside of the UK (and therefore free from UK VAT). Bilta subsequently sold the carbon credits back to UK VAT-registered companies at a slightly reduced price. The proceeds of such sales, including the VAT element, were paid either directly to Jetivia or received by Bilta, which then transferred the proceeds to third parties, including Jetivia. The activity resulted in Bilta becoming insolvent and unable to meet its VAT liability to HMRC in the sum of GBP 38 million.

Bilta's liquidators, on behalf of Bilta, commenced proceedings against the directors on the basis that the directors had conspired to defraud Bilta and were in breach of their fiduciary duties. It was further alleged that Jetivia and its chief executive officer, Mr Brunschweiler, a French resident, had dishonestly assisted the directors in committing the fraud. The liquidators also asserted that each of the appellants was liable for fraudulent trading pursuant to section 213 of the IA 1986.

The appellants sought to strike out Bilta's claim on the basis that:

1. they would be bound to defeat the claims by application of the principle of *ex turpi causa non oritur actio*, i.e. that Bilta would be unable to bring a cause of action based on its own illegal act; and
2. section 213 of the IA 1986 does not have extra-territorial effect and thus could neither apply to Jetivia, a Swiss company, nor Mr Brunschweiler, a French domicile.

The appellants' principal argument was that Bilta was not the victim of any wrong-doing on the basis that the fraud was against HMRC and the state of mind of Bilta's directors and its sole shareholder was attributable to the company, thus rendering Bilta a party to the wrong-doing. On this reasoning, the appellants argued that the claim of dishonest assistance and conspiracy was void as Bilta was barred from the illegality principle under *ex turpi causa non oritur actio*. The appellants failed in both the court of first instance and the Court of Appeal, before appealing to the Supreme Court.

1. *Ex turpi causa non oritur actio*

The principle of *ex turpi causa non oritur action* is a rule of public policy that is often referred to as the 'illegality defence'. At its heart is the premise that a wrong-doer should not be able to bring a claim at law that is founded in his own illegal or immoral action, the classic example being from 1725 when a highwayman was prevented from suing his partner in crime for a greater share of their ill-gotten gains.[2] The proposition that the

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1 *Jetivia SA and another v Bilta (UK) Limited (in liquidation) & others* [2015] UKSC 23.
2 *Everet v Williams.*

court will leave two quarrelling wrong-doers as it finds them has achieved wider recognition at common law and the famous highwaymen's case was approved in a US Appeals Court judgment on tax evasion in 2013.[3] In *Bilta*, as well as referring to the highwaymen's case, Lord Sumption approved the description of the statement at law of the illegality defence by Lord Mansfield CJ in *Holman v Johnson*[4] as follows:

> 'No court will lend its aid to a man who founds his cause of action on an immoral or an illegal act. If, from the plaintiff's own stating or otherwise, the cause of action appears to arise *ex turpi causa*, or the transgression of a positive law of this country, there the court says that he has no right to be assisted. It is upon that ground the court goes; not for the sake of the defendant, but because they will not lend their aid to such a plaintiff. So if the plaintiff and defendant were to change sides, and the defendant was to bring his action against the plaintiff, the latter would then have the advantage of it; for where both are equally in fault, *potior est conditio defendentis*.'

The illegality defence has therefore been a facet of English law for at least three hundred years, but, as noted by Lord Sumption, is one of the most heavily litigated rules of the common law and, as he put it, 'become encrusted with an incoherent mass of inconsistent authority'. The result of such 'fragmentation of the law' is that whilst their Lordships were unanimous in dismissing the appeal and ruling that the illegality defence was not available to Bilta's directors, they were not unanimous in their reasoning. There were four written judgments in total with disagreement as to a number of aspects of the law as it stands.

Whilst observing that *Bilta* was a case concerned with attribution, and that the attention of the arguments had been correctly focussed on that, Lord Neuberger observed that a number of points of dispute had arisen between their Lordships that, despite each of them finding common ground on which to dismiss the appeal, had yet to be resolved.

In particular Lord Neuberger was careful to note the differences espoused by Lord Sumption on the one hand and Lords Toulson and Hodge on the other in relation to a number of aspects arising from the case, in particular the correct approach to the illegality defence, the role of public policy and the proper interpretation of *Stone & Rolls v Moore Stephens*.[5]

The correct approach to the illegality defence

Lord Neuberger referred to the differing and strongly held views as to the correct approach that should be adopted towards the illegality defence, which he described as a spectrum of views epitomising the tension between the need for clarity and certainty with the equally important desire to achieve a fair and appropriate result.

Lord Sumption set out in detail the development of the law relating to *ex turpi causa*, explaining that at one stage the Court of Appeal had decided to treat the preceding body of authority on the subject as 'essentially discretionary', directed by the so-called 'public conscience' test. This was overruled by the House of Lords in *Tinsley v Milligan*[6] and reaffirmed *Les Laboratoires Servier v Apotex Inc.*[7] Lord Sumption's view was that these binding decisions had been effective in removing any element of judicial discretion in the area:

> 'the illegality defence is based on a rule of law on which the court is required to act, if necessary of its own motion, in every case to which it applies. It is not a discretionary power on which the court is merely entitled to act, nor is it dependent upon a judicial value judgment about the balance of the equities in each case: In the light of the rejection of the public conscience test, it is incumbent on the courts to devise principled answers which are no wider than is necessary to give effect to the policy stated by Lord Mansfield and are certain enough to be predictable in their application.'

Lords Toulson and Hodge by contrast pointed to the decision of the Supreme Court in *Hounga v Allen*,[8] in which conflicting aspects of public policy were weighed against each other to decide whether the *ex turpi causa* principle should defeat the claim. In that case, Lord Wilson held that the public policy rationale for preventing an illegally trafficked person from bringing a claim against her erstwhile employers on the grounds that she was a party to her own illegal trafficking, should give way to the public policy requirement that she should be protected from discrimination.

As Lords Toulson and Hodge pointed out, this approach came after *Tinsley* where the public conscience test had been rejected and yet this reasoning in *Hounga* was not disapproved by the Supreme Court in the later case of *Les Laboratoires Servier.*

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3 *Matthew Thomas et al v UBS AG* No.12-2724 US Court of Appeals for the Seventh Circuit.
4 (1775) 1 Comp 341.
5 [2009] 1 AC 1391.
6 [1994] 1 AC 340.
7 [2014] UKSC 55.
8 [2014] UKSC 47.

Lord Neuberger found it unnecessary for the purposes of this case to decide the correct approach as there had been no real argument on the topic in the case. He did, however, express his view that the question of the correct approach to the illegality defence ought to be decided by a full panel of the Supreme Court as soon as appropriately possible.

Attribution

Lord Sumption identified that the key question in relation to the applicability of the illegality defence to Bilta was whether or not the illegal acts of an agent should be attributed to his principal, in this case a company.

> 'As applied to the present case, it is whether the dishonesty which engages the illegality defence and is to be attributed to Bilta for the specific purpose of defeating its claim against the directors and their alleged co-conspirators. The question is whether the defence is available to defeat an action by a company against the human agent who caused it to act dishonestly for damages representing the losses flowing from that dishonesty.'

The primary rule of attribution, according to Lord Sumption, is that the company must necessarily have attributed to it the state of mind of its constitutional directing organ (whether board of directors or general body of shareholders), since a company as a legal construct must both think and act through agents. For Lord Sumption a distinction must be drawn between 'mere' vicarious liability that a company may incur as a strict liability as a principal for something done by its agent (and therefore does not involve any attribution of wrong-doing to the company) and direct or 'personal' liability, which is founded on culpability.

Lord Sumption went on to raise the fraud exception in relation to attribution, which he preferred to label the 'breach of duty exception' as it is not restricted to fraud. This exception, referred to as the *Hampshire Land* principle,[9] described by Lord Phillips in the House of Lords in *Stone & Rolls* is the principle that knowledge (as opposed to liability) of an agent's act cannot be attributed to a company when the knowledge relates to the agent's own breach of duty to the company. Lord Neuberger considered the breach of duty exception to be part of the general rule rather than an exception to the general rule.

Lords Toulson and Hodge, in their joint judgment, due to their view that the doctrine of illegality was subject to context and competing aspects of public policy, did not believe that the question of attribution or the *Hampshire Land* principle need arise. They considered the various attribution rules in any case, however, and concluded that the rules of attribution would reach the same result and approved the view of the Court of Appeal:

> 'In the present case Patten LJ rightly stated that attribution of the conduct of an agent so as to create liability on the part of the company depends very much on the context in which the issue arises. He said that as between the company and the defrauded third party, the company should be treated as a perpetrator of the fraud; but that in the different context of a claim between the company and the directors, the defaulting directors should not be able to rely on their own breach of duty to defeat the operation of the provisions of the Companies Act in cases where those provisions were intended to protect the company.'

Both Lord Neuberger (with whom Lords Clarke and Carnworth agreed) and Lord Mance, in their judgments agreed that the appellants' case would fail on the basis of attribution, with Lord Neuberger holding that:

> 'Where a company has been the victim of wrong-doing by its directors, or of which its directors had notice, then the wrong-doing, or knowledge, of the directors cannot be attributed to the company as a defence to a claim brought by the company's liquidator, in the name of the company.'

Lord Mance added that the general rules of agency cannot apply in questions of attribution, especially in a statutory context and that the key to any question of attribution is whose act or knowledge or state of mind for the purpose of the relevant statutory rule count as that of the company.

> 'Where the relevant rule consists in the duties owed by an officer to the company which he or she serves, then, whether such duties are statutory or common law, the acts, knowledge and states of mind of the company must necessarily be separated from those of its officer. The purpose of the rule itself means that the company cannot be identified with its officers. It is self-evidently impossible that the officer should be able to argue that the company either committed or knew about the breach of duty, simply because the officer committed or knew about it. This is so even though the officer is the directing mind and will of the company. The same clearly also applies even if the officer is also the sole shareholder of a company in or facing insolvency. Any other conclusion would ignore the separate legal identity of the company,

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9 From *Re Hampshire Land* [1986] 2 Ch 743.

empty the concept of duty of content and enable the company's affairs to be conducted in fraud of creditors.'

Public policy

Lords Toulson and Hodge agreed that the application must fail. Their reasoning was that if Bilta's directors, who were in sole control of the company, could raise illegality as a bar to the company enforcing its fiduciary duty towards it, then it would fatally undermine the legal principle of directors being required to act in good faith and in the interests of creditors of an insolvent company:

> 'It has been stated many times that the doctrine of illegality has been developed by the courts on the ground of public policy. The context is always important. In the present case the public interest which underlies the duty that the directors of an insolvent company owe for the protection of the interests of the company's creditors, through the instrumentality of the directors' fiduciary duty to the company, requires axiomatically that the law should not place obstacles in the way of its enforcement. To allow the directors to escape liability for breach of their fiduciary duty on the ground that they were in control of the company would undermine the duty in the very circumstances in which it is required. It would not promote the integrity and effectiveness of the law, but would have the reverse effect. The fact that they were in sole control of the company and in a position to act solely for their own benefit at the expense of the creditors, makes it more, not less, important that their legal duty for the protection of the interests of the creditors should be capable of enforcement by the liquidators on behalf of the company.'

They concluded that such an outcome would be contrary to public policy and undermine the purpose and terms of sections 172(3) and 180(5) of the Companies Act 1986, placing a duty on directors to have regard to creditors' interests and protecting creditors' interests.

In relation to public policy, Lord Sumption disagreed with Lords Toulson and Hodge that the application would also have been dismissed on the ground that the application of the illegality defence would be inconsistent with statutory policy requiring directors to have regard to the interests of creditors in the event of an insolvency or prospective insolvency of the company.

His reasoning was that the proper role of policy in the law of illegality is not to open up the weighing of discretionary factors by a court on a case-by-case basis, which would be a reversion to the pre- *Tinsley* public conscience test that the House of Lords had ruled against. Lord Sumption observed that the apparent differences in the later case of *Hounga* were not in fact a departure from the *Tinsley* approach, but simply recognition that in that case there was a competing public policy and that in either case, the illegality defence would have failed. He was also unwilling to make a judgment as to whether the directors' duties to creditors in the zone of insolvency would amount to a countervailing public policy, where those arguments had not been fully developed and it was unnecessary to do so when the key issue of attribution had been resolved.

Stone & Rolls

Stone & Rolls itself, according to Lord Sumption, despite the difficulty in following the majority decision in that case due to the number of conflicting views, could stand as authority only for the proposition that the illegality defence is available against a company only where it was directly, as opposed to vicariously, responsible for it. He concluded that in relation to Bilta, the exception applied and the illegality defence was not available to the directors.

Lords Toulson and Hodge concluded that *Stone & Rolls* should be treated with caution, owing to the lack of unanimity and the particular facts of that case. Lord Mance and Lord Neuberger separately disagreed with Lord Sumption's proposition that *Stone & Rolls* establishes a general distinction between personal and vicarious liability as central to whether the illegality defence is available. Lord Neuberger went further in relation to *Stone & Rolls*, suggesting that it be 'put on one side and marked "not to be looked at again"'.

2. Extra-territorial effect of section 213 IA 1986

The application of section 213 of the IA 1986 was dealt with in a more straightforward fashion. The English courts claim worldwide jurisdiction over the assets of a company which enters liquidation in order that they are properly distributed. Therefore, the efficiency of the winding up of a UK company would be seriously compromised if the court's jurisdiction did not extend to persons resident outside the UK. This is particularly so given the globalised nature of the British economy. The decision of the Court of Appeal in *Paramount Airways Limited*[10] was confirmed on this point.

The appellants' appeal on the territorial scope of section 213 of the IA 1986 was unanimously dismissed by the court, without the differences of opinion that the *ex turpi causa* issue had engendered.

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10 *In re Paramount Airways Ltd* [1993] Ch 233.

Section 213 of the IA 1986 provides as follows:

> '(1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.
>
> (2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.'

The appellants claimed that the reference to 'any persons' means only persons in the United Kingdom and that the provisions of section 213 of the IA 1986 therefore do not have extra-territorial effect and did not apply to either Jetivia or Mr Brunschweiler (domiciled in Switzerland and France respectively). The court considered that this argument was misconceived.

The appellants challenged whether the court is able to regulate the appellant's conduct abroad which falls to the construction of the relevant statute. The position has historically been that a UK statute would only apply to people in the UK or a foreigner present in the UK and therefore subject to the jurisdiction of the UK unless the relevant statute provided to the contrary.[11] However, as noted by Lords Toulson and Hodge, the principle has evolved over the years to an interpretation of the relevant statute.[12] It was noted by Lord Sumption in *Cox v Ergo Versicherung* that implied extra-territorial effect can arise in cases where 'the terms of the legislation cannot effectually be applied or its purpose cannot be achieved unless it has extra-territorial effect'.[13]

The court held that section 213 of the IA 1986 should properly have extra-territorial effect owing to its context in the liquidation of a company registered in the UK. The effect of section 213 of the IA 1986 is to provide a remedy against a person who is a party to the fraud and involved in the carrying on of the company's business (prior to its insolvency). As many modern UK companies increasingly trade and operate overseas, it would be highly impractical if the effect of a winding up order was not worldwide.[14] Lords Toulson and Hodge drew attention to this point at paragraph 213, expressing the view that:

> 'It would seriously handicap the efficient winding up of a British company in an increasingly globalised economy if the jurisdiction of the court responsible for the winding up of an insolvent company did not extend to people and corporate bodies resident overseas who had been involved in the carrying on of the company's business.'

As such, the court held that the correct decision was reached in *In re Paramount Airways Ltd*, where the court found that it had jurisdiction under section 238 of the IA 1986 (which provides for a court order against a person to reverse transactions at undervalue) to make an order against a foreign person. Sir Donal Nicholls VC noted that it was not the intention of parliament to impose a limitation on the phrase 'any person' in sections 238 and 239 of the IA 1986 and that the expression should therefore bear its literal and natural meaning. Furthermore, reference was made to the decision in *In re Seagull Manufacturing Co Ltd*, where Gibson J reiterated that parliament could not have intended for a person responsible for the state of an insolvent company's affairs to be able to escape liability because they were not resident in the jurisdiction.[15] The court held that both sets of reasoning were applicable to section 213 of the IA 1986 and that it therefore had extra-territorial effect.

In addition, Bilta's liquidators expressed the view that the English courts also held jurisdiction under article 3(1) Council Regulation 1346/2000 on insolvency proceedings (the 'European Insolvency Regulation'), which provides that:

> 'The courts of the member state within the territory of which the centre of a debtor's main interests is situated shall have jurisdiction to open insolvency proceedings. In the case of a company or legal person, the place of the registered office shall be presumed to be the centre of its main interests on the absence of proof to the contrary.'

In *Schmid v Hertel*, the Court of Justice of the European Union held that (i) article 3(1) conferred international jurisdiction to hear and determine actions derived directly from those proceedings which are closely connected with them, and (ii) the court of the relevant Member State has jurisdiction to hear and determine an action set aside as a transaction by virtue of insolvency that is brought against a person not resident in the territory of a Member State.[16] Bilta's liquidators argued that the European Insolvency Regulation therefore conferred jurisdiction on both appellants in

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11 *Ex p Blain* (1879) 12 Ch D 522, James LJ at p. 526.
12 *Clark v Oceanic Containers Inc* [1983] 2 AC 130, Lord Scarman at p. 145, Lord Wilberforce at p. 152; *Masri v Consolidated Contractors (UK) Ltd and others (no 4)* [2010] 1 AC 90, Lord Mance at para. 10.
13 *Cox v Ergo Versicherung* [2014] AC 1379, Lord Sumption at para. 29.
14 *Stichting Shell Pensioenfonds v Krys* [2015] 2 WLR 289 at paras 34 and 38.
15 *In re Seagull Manufacturing Co Ltd* [1993] Ch 345 p. 345.
16 *Schmid v Hertel* (Case C-328/12) [2014] 1 WLR 633 at paras 30 and 39.

addition to section 213 of the IA 1986. The appellants submitted that the decision in *Schmid v Hertel* was controversial and that reference to the Court of Justice of the European Union was required to determine whether section 213 was covered by the European Insolvency Regulation.

The court found that it was unnecessary to rely on the European Insolvency Regulation as the court interpreted *Schmid v Hertel* to determine if there was subject matter jurisdiction against Jetivia. In addition, the court was of the view that if the proceedings against Jetivia were not covered by the European Insolvency Regulation, it would nonetheless be covered by section 213 of the IA 1986 in domestic law. As such there was no need for reference to the Court of Justice of the European Union.

Practical implications for officeholders

It seems to be common sense that directors should not be able to attribute their own misconduct to the company they serve in order to circumvent their liability for breaching their fiduciary duties to that company. In this respect, the decision provides certainty and clarity for liquidators (and now administrators) considering actions against fraudulent directors and conspiring parties. In addition, the case provides comfort that this would also apply in claims brought against appellants based outside of the UK under section 213 of the IA 1986.

However, the judgments in *Bilta* also highlight the difficulty in application of the principles of *ex turpi causa* and, given the words of Lord Neuberger, show a measure of judicial enthusiasm to resolve this vexed issue of English law at the next opportunity.

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