GRR INSIGHT

Americas Restructuring Review 2020

Edited by
Richard J Cooper and Lisa M Schweitzer

AMERICAS
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2020

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Contents

Preface

Welcome to the *Americas Restructuring Review 2020*, one of *Global Restructuring Review*'s annual, yearbook-style reports.

Global Restructuring Review, for anyone unfamiliar, is the online home for international restructuring specialists everywhere, telling them all they need to know about everything that matters.

Throughout the year, *GRR* delivers pitch-perfect daily news, surveys and features, organises the liveliest events (under our *GRR Live* banner) and provides our readers with innovative tools and know-how products.

In addition, assisted by external contributors, we curate a series of regional reviews – online and in print – that go deeper into local developments than our journalistic output is able. The *Americas Restructuring Review*, which you are reading, is part of that series. It recaps the recent past and adds insight and thought-leadership from the pen of pre-eminent practitioners from all across the Americas.

Across 17 chapters and 208 pages, this edition provides an invaluable retrospective from 32 authors. All contributors are vetted for their standing and knowledge before being invited to take part. Together, our contributors capture and interpret the most substantial recent international restructuring events of the year just gone, supported by footnotes and relevant statistics. Other articles provide a backgrounder – to get you up to speed, quickly, on the essentials of a particular jurisdiction.

This edition is bigger than ever and covers Argentina, Bahamas, Bermuda, Brazil, Canada, the Cayman Islands, Chile, Dominican Republic, Mexico and the US (from several angles). It also includes two chapters on sovereign debt.

Among the nuggets you will find:

- a case study of the Noble Group's restructuring (the chapter of the Bahamas);
- a prediction on when Brazil's fabled new restructuring law might see the light of day;
- a request to Mexico's ruling party to amend the Concorso Law;
- clarification on when a foreign-to-foreign transfer may be "too foreign" for the purposes of US bankruptcy law;

- analysis of the (somewhat) contradictory Chapter 15 decisions in Oi, Agrigkor and QCOG; and
- a description of some new stratagems hedge funds and private equity funds have found to get high returns in rescue deals.

And much, much more. We hope you enjoy the review.

On behalf of *GRR*, I would like to thank the review's editors Richard Cooper and Lisa Schweitzer, of Cleary Gottlieb Steen & Hamilton, for the direction and energy they've given, and my colleagues Jon Allen and Adam Myers, in our production department, for changes to our design that provide a digest of each chapter for those short of time. Thanks to them, this is the finest review we've produced.

If readers have any suggestions for future editions, or want to take part in this annual project, my colleague and I would love to hear from you. Please write to insight@globalrestructuringreview.com.

David Samuels
Publisher
November 2019

Editors' Introduction

Richard J Cooper and Lisa M Schweitzer
Cleary Gottlieb Steen & Hamilton LLP

Across the Americas, countries vary in the extent to which a strong statutory insolvency framework has been implemented and how widely it is used, especially in cross-border cases. Despite the differences among jurisdictions, what is common across the Americas is an unmistakable trend to modernising insolvency regimes to facilitate corporate reorganisations.

This volume provides a general overview of domestic insolvency regimes in more than 10 different jurisdictions, and also highlights various interesting recent developments in domestic and cross-border insolvency laws across the Americas. Certain themes emerge from recent cases and legal developments.

Companies continue to explore ways to effectively and efficiently restructure their global businesses

In the United States, Chapter 15 of the US Bankruptcy Code continues to provide a vibrant path to implement and support foreign restructurings. Several articles in this volume highlight the recent trends emerging from the dynamic and still evolving Chapter 15 case law.

Foreign debtors are eager to seek recognition of their local restructurings under Chapter 15 because of its expansive scope and clear standards. As an initial matter, Chapter 15 has minimal property requirement. As 'US: Dynamic Trends in Chapter 15' notes, courts have confirmed that the property requirement to be a debtor under the US Bankruptcy Code and other gating requirements for Chapter 15 are set at a low threshold. In one case before the Bankruptcy Court for the Southern District of New York, a US$1,250 retainer placed in the foreign representative's US counsel's account was held to be sufficient to meet the relevant property requirement.[1] Additionally, Chapter 15 jurisprudence provides clear guidance on how to obtain recognition, and such recognition has generally been an effective way to enforce a restructuring plan against creditors given the use of NY law-governed debt and US courts' jurisdiction over most financial creditors in a typical case.

1 *In re B.C.I. Finances Pty. Ltd.*, 583 B.R. 288 (Bankr. S.D.N.Y. 2018).

That said, US courts have signalled their willingness to be gatekeepers when necessary, including where violations of public policy occur, or a debtor or its creditors have acted in bad faith. The public policy exception has been construed narrowly, being applied only when 'the most fundamental' policies of the United States are at stake.[2] As 'The High Burden to Satisfy Standard of Chapter 15' notes, only a handful of cases since 2005 successfully invoked this exception. As the volume of Chapter 15 precedents increases and US courts have more opportunities to examine different types of insolvency proceedings and restructuring plans sanctioned by foreign courts, the public policy doctrine is expected to be further refined, and courts may develop further guidance. For example, as 'US: Dynamic Trends in Chapter 15' notes, a US bankruptcy court recently noted that it may be possible to limit the scope of Chapter 15 recognition relief if the case is filed in bad faith, although this issue was not specifically ruled upon by the court in that case. Further developments in this area are expected.

Courts in other jurisdictions have shown a similar willingness and ability to handle cross-border and group insolvencies. For example, in the case of *SquareTwo*, the Canadian court was willing to grant an unprecedented pre-filing stay under seal while SquareTwo was preparing its pre-packaged Chapter 11 filing in the United States to prevent any actions that could disrupt SquareTwo's business and hinder the insolvency proceedings in the United States and in Canada. Another example is the case of *Noble Group Limited* in Bermuda, which involved the English and Bermuda schemes of arrangement, recognised in the United States under Chapter 15, pursuant to which certain assets would be transferred to New Noble Group. When the Singaporean authorities blocked the transfer of Noble Group's listing on the Singapore Exchange to New Noble Group, which threatened the successful implementation of the schemes, upon Noble Group's request, the Bermuda court appointed a provisional liquidator that was given sufficient latitude to implement the transfer of assets. We expect that courts will continue to develop tools and approve procedures that improve companies' ability to restructure, especially those companies with a multinational footprint.

Calls for legislative reforms on insolvency laws continue in countries where the domestic bankruptcy regime is underutilised

A number of insolvency regimes across the Americas are currently in their nascent stage. For example, the Dominican Republic's Insolvency Law was enacted less than five years ago and became effective in 2017. Practitioners and governments in other countries also continue their effort to develop the current regimes by proposing amendments to existing law and taking steps to get such changes approved. For example, Mexico enacted its Concurso Law in 2000 and more amendments followed in 2007, 2014 and 2019. Practitioners here point out various areas that can be further improved to make the Concurso regime even more effective, including methods to deal with challenges to the Concurso-related decisions; development of clear and uniform jurisprudence and perhaps specialised courts; and minimisation of statutory hurdles that make debtor-in-possession financing difficult to obtain. Practitioners are

2 H.R. Rep. No. 109-31, pt. 1, at 109 (2005).

hopeful that a Concurso reform may be possible given the recent change in the government resulting in one party having the majority control and the appointment of a new director of the Federal Institute of Specialists for Insolvency Procedures (IFECOM), an institute that serves as a quasi-judicial officer with certain responsibilities in the Concurso proceedings.

In Brazil, a major legislative reform is in progress and expected to be approved by the Brazilian Congress in the near future, driven by certain inefficiencies in the current insolvency regime that some say result in lower creditor recoveries and longer cases. The authors of the 'Brazil' chapter provide an overview of the key proposals included in the new reform bill. The new amendment aims to provide clearer rules for the sale of assets, to stimulate debt financing, and to provide somewhat more flexibility in the treatment of groups of companies as well as adoption and incorporation of the Model Law for Cross-Border Insolvencies. The proposed amendments include certain controversial provisions such as the one giving significant power to the treasury, even allowing it to file for liquidation of a restructured debtor if the tax claims are not dealt with in reorganisation. It will be interesting to see the final form of this legislation and whether it will lead to noticeable changes in practice.

Sovereign debt restructuring continues to present various legal, geopolitical and social challenges

In recent years, the world has witnessed a series of sovereign debt crises around the globe. These historical examples have demonstrated the potential additional complexities to debt holders recovering against a sovereign, given the foreign policy overlays and other potential hurdles in enforcing judgments against a sovereign government. However, such wrinkles have not prevented parties from finding creative and effective ways to deal with sovereign debts.

'Sovereign Debt Restructuring: A Latin American Perspective' provides an overview of various issues related to sovereign debts in Latin America, and highlights certain ways to increase creditor participation in sovereign debt restructuring that have been used, including voluntary exchange offers, exit consents and collective action clauses that discourage hold outs. The article presents a number of successful sovereign debt restructurings, including Uruguay's debt reprofiling via an exchange offer, and explains various mechanisms that Uruguay used in that transaction.

While market participants have turned their immediate attention to Argentina's liquidity problems and possible sovereign default, practitioners and academics have offered varying solutions to address Venezuela's existing default. Venezuela and its government-owned entities (including Petróleos de Venezuela, SA (PDVSA)) have outstanding debt claims of an estimated US$150 billion. Parties and advisers have developed creative and noteworthy proposals to tackle external debts of the government and its entities. They include:

- adopting a local reorganisation law for PDVSA and other state entities modelled on Chapter 9 of the US Bankruptcy Code (governing insolvency of municipalities) that would be supported by Chapter 15 proceedings in the United States or similar proceedings in other jurisdictions; and
- simultaneously negotiating a restructuring agreement with creditors holding sovereign claims using various contractual mechanisms to encourage creditor participation.

'Debt-Equity Conversion in Venezuela' explores a specific type of restructuring initiative that could be deployed in Venezuela: debt-to-equity conversions. The authors present debt-to-equity conversion options through which Venezuela's creditors can acquire debt claims against the country or its instrumentalities and exchange them for other assets such as equity interest in state-owned companies, including oil and gas joint ventures, and discuss potential challenges and issues that need to be considered.

Successful implementation of any of the proposed frameworks to restructure the country's debts will require significant political buy-in as it will depend on Venezuela's willingness to enact necessary amendments to its insolvency and restructuring regime, privatisations law or regulatory schemes for oil and gas joint ventures and other public sector entities.

The editors hope that this volume will provide a useful overview of recent developments and trends in insolvency laws across the Americas both in commercial and public spheres. As you will discover, this is an interesting time and many areas of insolvency-related laws are expected to be further refined and enhanced to meet the needs of debtors, creditors and other constituents.

Lisa M Schweitzer
Cleary Gottlieb Steen & Hamilton LLP

Lisa M Schweitzer's practice focuses on financial restructuring, bankruptcy, insolvency and commercial litigation. She has extensive experience advising corporate debtors, individual creditors and strategic investors in both US Chapter 11 proceedings and restructurings in other jurisdictions in North America, Europe and Asia.

Lisa has represented diverse companies and creditors in major US and cross-border bankruptcy proceedings, including in the PG&E, M&G Chemicals, SunEdison, EZRA, Inversiones Alsacia and Express de Santiago Uno, Nortel and Lehman bankruptcies.

Lisa received a JD from New York University School of Law and a BA from the University of Pennsylvania.

Richard J Cooper
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Richard Cooper's practice focuses on domestic and international restructurings, including sovereigns and municipal restructurings. He is recognised as one of the leading restructuring lawyers in the US and the 'go to' person for cross-border restructurings involving Latin America. Cooper has represented governments, state instrumentalities, creditors, debtors, buyers and sellers of distressed assets, creditor committees, DIP lenders and other participants in out-of-court and in-court bankruptcy proceedings. He has represented the governments of Mexico, Indonesia, Colombia and Puerto Rico in restructuring and liability management matters. Additionally, Cooper has been a thought leader on issues related to the possible restructuring of Venezuelan debt and has spoken and written extensively on the subject.

In Latin America, Cooper has advised on many of the most high-profile restructurings in recent years, including Oi SA, Odebrecht Oil and Gas, Tonon Bioenergia, GVO, Mirabela Nickel, Embratel, IMPSA and Odebrecht Engineering and Construction in Brazil; Arendal, Empresas ICA, Inbursa, CEMEX and Oro Negro in Mexico; Albanesi, San Antonio Oil and Gas, Edenor, Metrogas, Telecom Argentina and TGN in Argentina; and Automotores Gildemeister and Alsacia and Express in Chile, and in the US, the restructurings of Aleris, America West Airlines, Circle K, Insight Healthcare and Lehman Brothers, among others.

He received a JD from Columbia Law School, an MSc from the University of London, and a BA from Duke University.

CLEARY GOTTLIEB

Cleary Gottlieb's global restructuring and bankruptcy practice remains at the forefront of the most complex restructurings, consistently delivering sophisticated, effective and imaginative advice to clients globally.

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We continue to play central roles in the highest-profile Chapter 11 proceedings within the United States and the largest private restructurings outside the United States. Our precedent-setting sovereign practice represents numerous governments in their debt renegotiations and liability management transactions, advising clients such as as Argentina, Greece, Iceland, Iraq, Puerto Rico and Uruguay. Moreover, with our top-ranked M&A and tax practices, we provide invaluable strategic and transactional advice to both buyers and sellers, including some of the world's leading financial institutions, private equity firms, hedge funds, and public and private corporate acquirers. If matters get contentious, clients rely on our substantial experience in litigating insolvency-related matters before courts throughout the United States and Europe.

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In summary

This chapter explains the main features of the Argentine insolvency proceedings. Insolvency proceedings in Argentina are governed by the Bankruptcy Law, No. 24,522 as amended, which provides for two restructuring schemes: a formal full plenary reorganisation proceedings, similar to the reorganisation procedure regulated under Chapter 11 of the United States Bankruptcy Code, and an out-of-court reorganisation agreement, which is similar to the US prepackaged restructurings; and a liquidation proceeding.

Discussion points

- Reorganisation proceeding
- Out-of-court restructuring agreements
- Liquidation
- Prepetition void or voidable transactions
- Liability of shareholders, managers and other third parties
- Cross-border insolvencies

Referenced in this article

- The Bankruptcy Law, No. 24,522
- General Companies Law, No 19,550
- Civil and Commercial Code
- Criminal Code
- UNCITRAL Model Law on Cross-Border Insolvency

Reorganisation

Reorganisation proceedings in Argentina are only voluntary. Debtors may file a voluntary petition for reorganisation at any time prior to bankruptcy adjudication. Admission of the petition requires the filing of evidence showing that the debtor is insolvent (in 'payments cessation', or unable to comply with its current liabilities) and that at least one year has elapsed since a court declaration of performance of a prior reorganisation, if applicable.

In addition, debtors adjudicated bankrupt may request the conversion of the bankruptcy adjudication into a reorganisation proceedings to the extent that the bankruptcy was not adjudicated as a consequence of the breach of a reorganisation plan while a reorganisation proceeding was pending or before a year has elapsed since a court declaration of performance of a prior reorganisation plan.

Effects of commencement of a reorganisation

The commencement of a reorganisation proceedings has the following main effects:

- the debtor keeps in possession but the administration of its assets is subject to the supervision of a receiver appointed by the court;
- all creditors will be required to file proof of claims before the receiver;
- in the case of need or urgency, the court may order the temporary suspension of secured credits enforcement and precautionary measures on collateral secured with mortgage or pledge for a period of no more than 90 days (interests accrued during the suspension will enjoy the preference of administrative expenses);
- the debtor is banned from entering into any transactions without consideration or that may affect the status of prepetition claims;
- within the 10 days following the filing by the receiver of the report on labour claims, the court will authorise the 'prompt payment' of the labour claims without need to file proof of claims;
- any of the following transactions requires the prior authorisation of the court, after a hearing with the receiver and the creditors' committee: transactions on registered property; disposition or lease of goodwill; issuance of secured bonds; granting of pledges; and any other transaction not within the ordinary course of debtor's business;
- the accrual of interest on prepetition unsecured claims is suspended; and
- all proceedings in connection with prepetition unsecured monetary claims are stayed, and are consolidated at the court that is the venue for the reorganisation proceedings.

The reorganisation plan

Creditors must be classified in at least three categories: unsecured creditors, labour creditors and secured creditors. The debtor may also create additional categories within each of the foregoing based on objective criteria. Each class could be offered different reorganisation proposals.

The debtor enjoys a non-compete or exclusivity 90-day period, extendable by up to 30 additional days (the exclusivity period) during which it must formulate a reorganisation plan and obtain the consent of the required majorities of creditors.

The plan must be consented to by unsecured creditors (excluding controlling shareholders) representing, within each class of unsecured creditors, more than 50 per cent of all unsecured creditors, determined on a headcount basis and at least 66.66 per cent of the aggregate principal amount (plus accrued interest as of the petition date) (the requisite majorities).

Consent of creditors holding debt securities issued in series (ie, notes) must be granted at a holders' meeting for each series or in such other manner as provided in the indenture, subject to the court's discretion. Securities holders' meetings are subject to the following rules:

- for purposes of computing the headcount majority, all votes of each series consenting to the plan will be computed as given by one person and all votes rejecting the plan will be computed as given by one person; and
- the aggregate principal amount of the securities held by the holders consenting to the plan will be computed for determining the principal majority, provided that for the purposes of calculating the principal majority the principal amount of the notes not appearing at the meeting or otherwise not voted will not be computed.

Any proposal to secured creditors must be approved by unanimous consent of those creditors.

Challenge and failure of the reorganisation

Creditors with voting rights on the plan and those that have initiated ancillary proceedings for late filing of proof of claims or disallowance can challenge the plan only on the following grounds:

- irregularities in the computing of the required majorities;
- lack of powers of the creditors' representatives who consented to the plan and whose vote was necessary for obtaining the required majorities;
- fraudulent increase in liabilities;
- concealment or fraudulent exacerbation of the assets; and
- breach of material formalities in the process (only creditors not consenting to the plan).

The reorganisation plan may also be challenged if its terms are deemed abusive (highly disproportionate). However, in this case, in general the courts have granted the debtor an opportunity of improving the terms of the plan, with or without the need for new consent from the creditors (what has been called the 'third way'). The court resolution admitting the challenge will include the bankruptcy adjudication and the resolution rejecting the challenge will include the endorsement of the plan.

In addition, a plan duly endorsed may be declared null and void by request based on the wilful exacerbation of the liabilities, recognition or simulation of non-existent or unlawfully granted securities, concealment or exacerbation of the assets, which become known after the statutory term for challenging the plan (as described above) has elapsed. The court resolution admitting the petition will include the bankruptcy adjudication.

If, at the end of the exclusivity period, the debtor does not receive approval for the plan from the required majorities, the court may exercise the cramdown power and therefore endorse the plan if:

- the plan was approved by the requisite majorities within at least one of the impaired classes of unsecured creditors and unsecured creditors representing at least three-quarters of the aggregate principal amount of the impaired unsecured credits;
- the plan does not discriminate the opposing classes by banning the creditors of such classes from choosing among the available alternative reorganisation options, if any, or otherwise the consideration received by the opposing classes is not of inferior value than that received by the accepting classes; and
- payment received under the plan is not less than the dividend the opposing creditors would receive in the liquidation.

If the court does not exercise the cramdown power, then the court will declare the debtor bankrupt. If the debtor is a limited liability company, corporation, cooperative or company with state participation, before declaring the debtor bankrupt, the court must open a five-day period for the registration of the creditors, workers' cooperative or other third parties interested in acquiring the debtor's equity and formulate alternative competing reorganisation plans. The debtor may also file a new competing plan. If there is no alternative reorganisation plan or no plan is consented to by the requisite majority of creditors, then the court will declare the debtor bankrupt.

If the debtor fails to perform the plan, wholly or partly, the court will declare it bankrupt upon the request of the creditors or the controlling committee. The court will adjudicate the debtor bankrupt without petition if the debtor declares that it is impossible for it to comply with the plan in the future.

Conclusion of the reorganisation

A reorganisation proceeding may be concluded by involuntary withdrawal if the debtor fails to:

(i) deliver the corporate books to the court or to deposit the amounts for the payment of mailing notices within the three days of the reorganisation commencement resolution notice; or

(i) publish the commencement notices within five days of the reorganisation commencement resolution.

In addition, a reorganisation proceeding may be concluded by voluntary withdrawal prior to the first publication of notices, without the consent of the creditors, or prior to the beginning of the exclusivity period, with the consent of unsecured creditors holding at least 75 per cent in principal amount of unsecured claims.

Once the plan is endorsed and performed, at the request of the debtor the court will issue a resolution declaring the reorganisation concluded, finalising the intervention of the receiver, and a resolution declaring the reorganisation plan performed.

Out-of-court restructurings

The out-of-court restructuring consists of an agreement that the debtor enters into with all or a portion of its unsecured creditors (classified under objective criteria similar to that of the reorganisation proceedings) for the restructuring of their unsecured claims. If the agreement is executed or consented to by unsecured creditors representing the requisite majority, the agreement may be filed for court endorsement, upon which the restructuring will be binding against non-party unsecured creditors.

Admission of the petition does not necessarily require the filing of evidence showing that the debtor is in cessation of payment and is sufficient proof that the debtor is experiencing financial difficulties.

Effects of admission of an out-of-court restructuring

Upon admission of the out-of-court restructuring, all prepetition unsecured claims against the debtor are automatically stayed. The admission of the petition does not have an effect on secured claims.

The terms of the restructuring

The out-of-court restructuring agreement is subject to the same terms and requirements of a reorganisation plan.

Other than the general principles of law and the laws in effect from time to time, there are no limitations to the restructuring terms. With certain limited exceptions, discussed below, the Bankruptcy Law (ABL) does not provide for a substantive review of the restructuring terms under the out-of-court restructuring.

The unsecured creditors can be classified based on objective criteria and each class could be offered different restructuring proposals, provided that each proposal is consented to by the requisite majority of the unsecured creditors within each category.

Challenge and failure of the out-of-court restructuring

The unsecured creditors listed by the debtor upon filing the petition for endorsement of the out-of-court restructuring, and those showing proof of having been excluded from this listing, may challenge the out-of-court restructuring agreement based exclusively on omissions or exacerbations of the assets or liabilities or the lack of the requisite majorities. However, the agreement may also be challenged if its terms are deemed abusive (highly disproportionate).

Even if the out-of-court restructuring agreement is confirmed, it may be declared null and void upon a motion filed after confirmation based on wilful misrepresentation in the assets and liabilities statement, or the creation of illegitimate preferences in favour of certain creditors.

Liquidation

Bankruptcy petition

Under the ABL, a bankruptcy proceeding may be commenced either voluntarily, upon the petition of the debtor, or involuntarily, upon the petition of a creditor. It is a condition of filing the petition that the debtor be insolvent.

After an involuntary petition is filed, the court summons the debtor to file evidence of solvency (generally achieved through the deposit of the amounts owed to the petitioner). If the debtor does not file evidence of solvency, the court will adjudicate the debtor bankrupt. After bankruptcy adjudication, the debtor may file a petition for converting the bankruptcy adjudication into a reorganisation.

The bankruptcy proceeding

Upon bankruptcy adjudication, the court will appoint a receiver who will take possession of all the assets of the debtor.

All creditors must file proof of claims, preferences and priorities and provide the receiver with information as to the total amount, reason and privileges of each claim.

The commencement of a bankruptcy proceeding has, inter alia, the following main effects:

- actions taken by the debtor in respect of property of the estate, as well as payments made or received, are void by operation of law;
- the debtor's former managers are required to relinquish custody of the business, including all books, records, real property and equipment, to the receiver and are required to provide the court all assistance required;
- the accrual of interest on unsecured claims is suspended;
- all actions to enforce unsecured claims against the debtor that are not secured by a pledge or mortgage are suspended and the commencement of similar actions against the debtor are prohibited;
- all actions on unsecured claims against the debtor are consolidated before the court hearing the bankruptcy; and
- all pending payment obligations of the debtor are accelerated, so that all such obligations are treated as due as of the date of the filing of the bankruptcy petition.

If there is no decision on the continuation of the debtor's activities, the receiver will conduct the liquidation of the assets of the estate.

The receiver will file with the court a proposal for the distribution to the creditors of the proceeds obtained from the liquidation of the debtor's assets, considering the rank of each credit in the payment allocation provided by the ABL as described below.

After liquidation, expenses and claims enjoy the following order of preference in payment:

- claims with special preference, with priority of payment in respect of the proceeds of the assets affected in each case (including credits secured with mortgage or liens);
- administrative expenses (including debts incurred in connection with the administration of the case and with the maintenance, administration and liquidation of the property of the estate);

- claims with general preference (including certain labour claims and the principal amount of contributions to social security and taxes, excluding interest);
- unsecured claims; and
- subordinated claims.

Prepetition void or voidable transactions

Upon adjudication of bankruptcy, the court will fix the debtor's cessation of payment date (insolvency date), which cannot be more than two years before the reorganisation petition date (if bankruptcy is adjudicated as a consequence of the failure of a reorganisation) or the bankruptcy adjudication date (if bankruptcy is adjudicated directly). The period from the date of cessation of payment to the reorganisation petition date or the bankruptcy adjudication date is defined as the clawback period.

The following transactions made by the debtor within the clawback period are void:

- transactions without consideration;
- advance payments on debts that are due on or after the bankruptcy adjudication date; and
- granting of security or any other preference in respect of debts not due and not originally secured.

Any other transactions detrimental to the debtor's creditors made by third parties with knowledge of the debtor's insolvency during the clawback period are voidable. The third party has the burden of proving that the transaction did not cause any detriment to the debtor's creditors.

Liability of shareholders, managers and other third parties

Liability of 'limited liability' shareholders

There are certain grounds of joint and several liabilities of 'limited liability' shareholders under the General Companies Law, No. 19,550 (GCL). The shareholders are liable for the damage caused to the debtor as a result of their wilful misconduct or negligence and for any damage caused by acts of the debtor that concealed the shareholders' pursuit of their own interests or that constituted a cover for shareholders breaching the law, violating principles of public policy or good faith, or frustrating third parties' rights (piercing of the corporate veil).

In addition, under the ABL, the bankruptcy of a debtor may be extended to its controlling shareholders:

- who used the debtor to perform acts in their own interest and to the detriment of the debtor's interest, and disposed of the debtor's assets as if they belonged to them, deceiving the debtor's creditors;
- who unlawfully diverted the debtor's corporate interest, subjecting it to a unified management in the interest of the controlling shareholders or their group; or
- with respect to whom there is confusion regarding ownership of the assets of the debtor, or a major part thereof, that impedes the clear delimitation of the assets and liabilities of each of the parties.

Liability of managers and other third parties

Pursuant to the GCL, the managers of the debtor are jointly and severally liable for all damages arising from the breach of their fiduciary duties, the law or the by-laws and in general for any damage deriving from their wilful misconduct, abuse of powers or gross negligence, either by action or omission.

Under the ABL, the managers that wilfully provoked, facilitated, allowed or aggravated the debtor's financial situation or its insolvency are liable for the damages. Any third party (including the shareholders) who wilfully participated in acts leading to the depletion of the debtor's assets or to unduly increase the debtor's liabilities (the 'exaggeration' of the debtor's liabilities), before or after the adjudication of bankruptcy, are liable for damages. The liability described in the foregoing also extends to all acts carried out up to one year prior to the cessation of payment date. Scholars and recent case law confirm that the liability described above requires wilful misconduct.

Pursuant to the Civil and Commercial Code, fraudulent transfers, which have the effect of provoking or aggravating the insolvency of the debtor, between the debtor and a third party who knew, or should have known, the insolvency situation of the debtor, are subject to the civil fraudulent conveyance action. The third party that contracted with the debtor is liable for the damage arising from the transaction against the creditors making the claim. If the third party acted in good faith, his or her liability will be limited to the amount that he or she gained from the transaction.

The Criminal Code provides sanctions of imprisonment for the fraudulent breach of the director's duties. Any individual wilfully preventing the exercise of a creditor's right on an asset or guarantee and any debtor adjudicated bankrupt that has deceived its creditors, or made sales in detriment to them, may be prosecuted for fraud.

In addition, pursuant to the ABL, if, after realisation of all assets of the estate, the proceeds are insufficient to satisfy the insolvency proceedings' costs and expenses – including court tax and professionals' fees – then the liquidation procedure is closed for lack of assets and, in such case, the ABL creates a presumption of fraud and provides that the court must give notice to the criminal courts for prosecution.

Cross-border insolvencies

Argentina has not yet adopted the UNCITRAL Model Law on Cross-Border Insolvency and does not recognise effects to main foreign insolvency proceedings of foreign debtors against creditors holding claims payable in Argentina.

Pursuant to the ABL, the commencement of an insolvency proceeding in a foreign jurisdiction constitutes grounds for the filing of a petition for a full plenary liquidation case in respect of the foreign debtor's assets in Argentina.

The ABL provides for three additional principles in cross-border insolvencies, as outlined below.

The principle of preference for creditors participating in the Argentine liquidation process

In foreign creditors' liquidation process in Argentina, the creditors participating in the foreign liquidation process will only have the right to get the turnover of the debtor's remaining assets balance after all the claims of the creditors participating in the Argentine liquidation process have been fully satisfied.

The principle of reciprocity

Participation in an Argentine liquidation case of creditors holding claims payable outside of Argentina, and not participating in a foreign liquidation process, is conditioned upon filing of evidence that, reciprocally, creditors holding claims payable in Argentina are permitted to participate in a liquidation process commenced at the jurisdiction where such claims are payable in equal conditions with the domestic creditors of such jurisdiction. However, an exception is made with respect to creditors holding claims secured with mortgages or liens.

The principle of dividend parity

Payment received by unsecured creditors in a foreign jurisdiction after commencement of a liquidation case under the ABL shall be computed based on the general distribution available to such creditors on account of payments of unsecured claims under the Argentine liquidation process.

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Fernando Hernández joined Marval, O'Farrell & Mairal in 2002 and became partner in 2011. Since 2015, he has been the head of Marval, O'Farrell & Mairal's insolvency and restructuring department. He received his law degree from the Buenos Aires University School of Law in 1994 and obtained an LLM at Columbia University School of Law in 2001.

During the past decades, Hernández has been involved in advising either the debtor or creditors in some of the major international financial restructurings, out-of-court restructuring agreements and reorganisations, including Supercanal SA's reorganisation Chapter 15 petition; the US$135 million Inversora Eléctrica de Buenos Aires SA out-of-court restructuring; the KLP Emprendimientos SA reorganisation; the Sociedad del Plata reorganisation; the Supercanal SA US$104 million reorganisation and US$305 million principal amount secured notes cancellation; the US$800 million Cablevisión SA out-of-court restructuring; and the US$150 million Compañía de Alimentos Fargo SA reorganisation.

Hernández has advised both debtors and creditors, has vast experience in cross-border reorganisations and is skilled in advising on complex restructuring cases. With a lot of experience in corporate finance and capital markets, Hernández's knowledge of the insolvency proceedings is complemented by his demonstrated knowledge and experience in financial matters. His extensive experience in both procedural and financial matters give him an integral view of restructurings, which allows him to add great value to the planning of the process and strategy, and the formulation of reorganisation proposals.

Hernández has written many articles on his specialisation, both domestic and international, and is a member of the Buenos Aires Bar Association, the American Bar Association, INSOL International, the International Insolvency Institute and the American Bankruptcy Institute.

Founded in 1923, Marval, O'Farrell & Mairal is the largest law firm in Argentina. A market leader at both local and Latin American levels, the firm has been providing sophisticated, high-quality advice to international and local clients for more than 95 years. The firm comprises more than 300 lawyers and has wide experience of international business issues and the complexities of cross-border transactions.

Marval has a strong focus on high-end corporate and finance transactions and the largest, most active litigation and arbitration practice in Argentina. The firm's leading intellectual property department provides a comprehensive service and has unrivalled experience. Marval is also a market leader in a wide range of other key practice areas including tax, labour and employment, competition and antitrust, energy and natural resources, administrative and public law, insurance and reinsurance, telecommunications and broadcasting, and real estate and construction.

Marval offers the largest insolvency and restructuring multidisciplinary expert team in Argentina. Marval's insolvency and restructuring department offers unrivalled advisory and litigation experience in sophisticated cross-border insolvency proceedings, international restructuring cases and international financing restructurings. The team has consistently had a leading role in most of the major international high-profile restructurings in Argentina during the past two decades.

The department advised debtors and their shareholders, creditors, managers, investors and trustees in a wide range of industry sectors on private financial restructurings, out-of-court restructurings (pre-pack agreements), reorganisation proceedings, bankruptcy and liquidations.

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In summary

This chapter provides a summary on the current position under Bahamian law as it relates to the extraterritorial reach of clawback claims, winding up of mutual funds on just and equitable grounds, anti-suit injunctions, recognition and assistance in cross-border proceedings and the recognition of a foreign court-appointed receiver and the appointment of provisional liquidators.

Discussion points

- The Privy Council has determined clawback claims can be served outside of the jurisdiction on a foreign creditor
- The Companies Winding Up Amendment Act 2011 has modernised Bahamian insolvency laws
- International cooperation has been extended by virtue of the Foreign Proceedings (International Cooperation Rules) 2012
- Foreign court-appointed receivers can be recognised In the Bahamas, which may occur also in the context of enforcement of foreign judgments

Referenced in this article

- Supreme Court Act 1997
- International Business Companies Act 2000
- Bankruptcy Act 1870
- Companies Winding Up Amendment Act 2011
- Companies Liquidation Rules
- Rules of the Supreme Court 1978
- Foreign Proceedings (International Cooperation Rules) 2012
- Foreign Proceedings (International Co-Operation) (Relevant Foreign Countries) Liquidation Rules 2016
- Insolvency Practitioners Rules 2012
- Reciprocal Enforcement of Judgments Act 1924

Introduction

The Bahamas has long been established as an international financial centre in which foreign companies, complex commercial funds and special purpose vehicles invoke the jurisdiction of the Bahamian court for the purpose of incorporating offshore entities and carrying on business. When one of these companies experiences financial difficulties or enters into restructuring processes that involve assets, subsidiaries or structures located in the Bahamas, stakeholders are able to engage the Bahamian court to utilise not only the insolvency regime in the Bahamas but also its cross-border insolvency procedures.

The Commercial Division of the Supreme Court of the Bahamas (the Supreme Court) is dedicated to handling complex commercial cases including assisting financially distressed companies in the execution of cross-border restructuring. Appeals from the Supreme Court are to the Court of Appeal, and Her Majesty's Privy Council sits at the apex of the Bahamian court system as the final court. The competence of the Bahamian court system is evidenced by the fact that Justice Telford Georges, a former chief justice of the Bahamas, and Justice Edward Zacca, a former president of the Court of Appeal, who are eminent Caribbean judges, have both been members of Her Majesty's Privy Council.

Treatment of avoidance claims and fraudulent preference claims

In 2019, the Privy Council determined that a liquidator of a Bahamian company can pursue claims overseas where it has been alleged that a creditor has been preferred over others within the statutory period preceding the insolvency of the Company.

In the case of *ZCM Asset Holding Company (Bermuda) Ltd and AWH Fund In Liquidation* JCPC 2018/0033, despite the absence of express statutory provisions permitting service out of the jurisdiction of fraudulent preference claims, such claims were held to have extraterritorial effect.

An investor in a mutual fund, ZCM Asset Holding Company (Bermuda) Ltd (ZCM) subscribed for shares in AWH Fund (AWH) on behalf of a third party, American Express Alternative Offshore Investments Ltd (AMEX). The liquidator alleged that ZCM redeemed shares within the three-month statutory period, which could warrant such a payment being set aside as a fraudulent preference. An application was brought by way of summons filed in the liquidation proceedings pursuant to Order 11 Rule 8(4) for ZCM, to be served outside of the jurisdiction in Bermuda. The relief sought was a declaration that the payment made to ZCM was void as undue or a fraudulent preference, pursuant to section 160 of the International Business Companies Act (IBC Act) and set aside accordingly.

At first instance, it was held that there was no statutory jurisdiction to permit such service out of the jurisdiction. However, on appeal to the Court of Appeal of the Commonwealth of the Bahamas, it was determined that the IBC Act was intended to have extraterritorial effect as it was of application to investors who carried on business outside of the Bahamas.

In resolving the matter, the Privy Council adopted an extraterritorial approach to the IBC Act within the scope of insolvency proceedings. The test as to whether a payment made to a creditor constitutes a fraudulent preference is set out in section 72 of the Bankruptcy Act 1870, which requires an intention to prefer a creditor over other creditors in making the payment within three months of the bankruptcy. The board was required to consider the Bankruptcy Rules of 1871, which did not create jurisdiction for service of a fraudulent preference claim outside of the jurisdiction. The liquidator sought recourse to do so by virtue of Order 11 of the Rules of the Supreme Court 1978 (RSC), which conferred the statutory power to serve proceedings outside of the jurisdiction, including an interlocutory summons. However, it was held

> *Ord 1 rule 2(2) is a self-denying ordinance by which the RSC 'shall not have effect in relation to . . . proceedings relating to the winding up of companies [under the] Companies Act, Part VII.'*

Given that the RSC do not apply to proceedings relating to the winding up of companies, ZCM argued that they could not be relied on as the Bankruptcy Rules were the relevant rules of application.

Agents and nominees may be held liable

It was further argued that ZCM was not a proper party to the proceeding, as ZCM's position was analogous to that of bare trustee and that its position was the same as that of an agent who, in good faith, hands money received for his or her principal's account to his or her principal and is not liable to repay it if it turns out to be a fraudulent preference. Additionally, it was argued, in the circumstances, that the evidence that the dominant intention to prefer has to be shown and that an intent to prefer could not be inferred. Moreover, it was argued that the choice of law clause in the subscription agreement could not apply to the liquidator's present claim.

The board determined at [74]–[79] that after considering the jurisdictional requirements a claimant must meet on an application for leave to serve out of the jurisdiction (ie, that there must be a good arguable case). However, the board did not agree that there has to be direct evidence of an intent to prefer, which it was held can be inferred from other evidence. The board determined at [81] that there must be plausible evidential basis for inferring that, when it redeemed the shares registered in the name of ZCM, AWH knew itself to be insolvent and that it accordingly had the requisite dominant intent to prefer. The evidence of ZCM that other requests were made after its clients and that they were redeemed in August would not, in itself, according to the board, be sufficient to negate any intent to prefer.

It was therefore held that ZCM was the registered holder of the shares and when it became a member of AWH it became a party to AWH's articles of association. Further, article 2.06 of AWH's articles of association provided, in the usual way, that the company was entitled to recognise the registered holder as the sole owner.

The Privy Council stated at [82]:

> *Those articles mean that ZCM agreed to stand in the relationship of principal as regards AWH. There was nothing before the Board to suggest that AWH had agreed that any other person should be treated as the registered holder. ZCM held the legal chose in action resulting from the redemption request and it would have been the proper claimant to sue for the unpaid redemption monies.*

Ultimately, it was determined that ZCM is the right respondent to the summons and that it remains open to ZCM to pursue any remedy it has against the persons it paid.

The effect of this decision is that it clarifies the law as it relates to the extraterritorial effect of fraudulent preference claims. However, it also creates difficulties for subscribers to mutual funds, who may be held liable for investments made on behalf of third-party beneficiaries who are the ultimate recipients of payments.

Just and equitable winding-up petitions available to shareholders and anti-suit injunctions to restrain foreign proceedings

The Bahamas has enacted into its insolvency legislation express provisions whereby a shareholder may petition the Supreme Court to wind up a company in order to seek relief where it is just and equitable to do so. Pursuant to section 190 of the Companies Winding Up Amendment Act 2011 (CWUAA):

> *(1) An application to the court for the winding up of a company shall be by petition presented either by . . . (c) any contributory or contributories; . . .*

However, a contributory[1] is not entitled to present a winding-up petition unless either:

- the shares in respect of which he or she is a contributory, or some of them, are partly paid; or
- the shares in respect of which he or she is a contributory, or some of them, either were:
  - originally allotted to him or her, or have been held by him or her, and registered in his or her name for a period of at least six months immediately preceding the presentation of the winding-up petition; or
  - have devolved on him or her through the death of a former holder.

According to section 191(3), if the petition is presented by members of the company as contributories on the grounds that it is just and equitable that the company should be wound up, the court shall have jurisdiction to make the following orders, as an alternative to a winding-up order, namely:

- an order regulating the conduct of the company's affairs in the future;
- an order requiring the company to refrain from doing or continuing an act complained of by the petitioner or to do an act that the petitioner has complained it has omitted to do;
- an order authorising civil proceedings to be brought in the name and on behalf of the company by the petitioner on such terms as the court may direct; or
- an order providing for the purchase of the shares of any members of the company by other members or by the company itself and, in the case of a purchase by the company itself, a reduction of the company's capital accordingly.

1 According to section 183 of the CWUAA 'contributory' means (i) every person liable by virtue of this Act to contribute to the assets of a company in the event that it is wound up under this Act; and (ii) every holder of fully paid-up shares of a company.

As it relates to the procedure for a just and equitable winding-up petition, Order 3, Rule 11 of the Companies Liquidation Rules (CLR) states that upon the presentation of a petition by a contributory seeking a winding-up order or an order for alternative relief under section 191(3) of the CWUAA on the grounds contained in section 186(e),[2] the petitioner must at the same time issue a summons for directions in respect of the matters contained in this rule.

Upon hearing the summons for directions, the court shall give such directions as it thinks appropriate in respect of the following matters:

- whether or not the company is properly able to participate in the proceeding or should be treated merely as the subject matter of the proceeding;
- whether the proceeding should be treated as a proceeding against the company or as an inter partes proceeding between one or more members of the company as petitioners and the other member or members of the company as respondents;
- service of the petition;
- whether, and if so by what means, the petition is to be advertised;
- whether the petitioner should serve any further particulars of his or her claim;
- service of a defence by the company or the respondents (as may be appropriate in light of the directions given under paragraphs (a) and (b) of this rule);
- the manner in which evidence is to be given;
- if evidence is directed to be given by affidavit, directions relating to cross-examination of the deponents;
- discovery and inspection of documents; and
- oral discovery; and such other procedural matters as the court thinks fit.

A summons for directions under Rule 11 shall be served upon the company and upon every member whom the petitioner has named or intends to name as a respondent to the petition.

In the cases of *In the Matter of Pharmainvest Fund Ltd, Emerging Income Fund Ltd*, and *Emerging Value Opportunities (Bahamas) Ltd and In the Matter of the International Business Act*[3] (pending), three winding-up petitions were filed by a shareholder seeking to wind up three mutual funds incorporated under the Investment Funds Act on the basis of loss of substratum.

The application involved a master-feeder fund structure in which Bahamian companies were coupled with Delaware partnerships, which held similar names to the Bahamian feeder-fund companies. All of the assets of the Delaware partnerships were invested in a master

2 Section 186 of the CWUAA provides the circumstances in which a company may be wound up by the court:

> *A company may be wound up by the court if (a) the company has passed a resolution requiring the company to be wound up by the court; (b) the company does not commence its business within a year from its incorporation, or suspends its business for a whole year; (c) the company is insolvent; (d) the members are reduced in number to less than two; (e) the court is of the opinion that it just and equitable that the company should be wound up;or (f) a regulator petitions for the winding up of a company over which it has regulatory authority and whose licence or registration has been suspended or revoked.*

3 2000 Action No. COM/com 14, 15 and 16 of 2018.

account, which was also a Bahamian company. The structure included three Bahamian international business companies (the Bahamian feeder funds); three Delaware-based limited partnerships (the US feeder funds); and three Bahamas-based exempted limited partnerships, which act as master accounts and that purportedly conducted all principal investment trading. The two feeder funds were used to receive the investments of underlying participant investors and those investments were then fed into the master accounts. Together, each of the three entities make up a 'fund' that collectively the offering memoranda said would be invested in securities in emerging markets for pharmaceuticals believed to be undervalued but that possessed above-average yield potential.

A contributory petitioned on 20 March 2018 to wind up the three Bahamian companies that had been suspended for over nine years, essentially converting what was represented as being an open-end fund into a closed-end fund. The petition was for a just and equitable winding up; it was the petitioner's position that the funds no longer had a purpose given that the purpose of an investment fund was no longer met as required in accordance with section 1 of the Investment Funds Act 2003.

Loss of substratum

According to the Investment Funds Act, an 'investment fund' or 'fund' means:

- a company (including a limited duration company) that issues or has equity interests the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and achieving profits and gains arising from the acquisition, holding, management or disposal of investments, which is incorporated or registered in the Bahamas, of which the administrator, the investment adviser or the investment manager is either a company or companies incorporated or registered in the Bahamas or one or more companies or individuals any one of whom has a place of business in the Bahamas or which uses an address in the Bahamas, or the administration or management of which (including the control of substantially all of its assets) is carried on in or from the Bahamas; or
- a partnership that issues or has equity interests the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and achieving profits and gains arising from the acquisition, holding, management or disposal of investments, of which one or more of the general partners is incorporated or registered in the Bahamas or is a person residing in the Bahamas or uses an address in the Bahamas, whose partnership articles are governed by the laws of the Bahamas, or of which the administrator, the investment adviser or the investment manager is either a company incorporated or registered in the Bahamas or a person who has a place of business in the Bahamas or uses an address in the Bahamas.

The petitioner sought directions that the matters be dealt with jointly and for further relief, including:

- an order that leave also be granted to petition to wind up the master accounts;
- that the liquidator, if so appointed, on behalf of the company, as creditor of the master accounts, be authorised to appoint an interim receiver or that he or she be appointed

receiver to take control of the master accounts pending the hearing of the application to wind up the master accounts;
- an order directing that in the event that leave is given to wind up the general partners of the master accounts that those proceedings be joined to the present proceedings;
- that the directors of the companies and the investment manager, the general partner, do appear to be examined as to the management and affairs of the company; and
- that the chief investment officer of the investment manager, delivers up to the interim receiver all documents in his or her possession and furnishes all information concerning the use of the company's liquid assets, and any securities held on its behalf to the appointed interim receiver, together with books, records, documents, and financial statements and accounts relating to the company.

The core of the petitioner's complaint was that the liquid funds of the companies were pooled and wrongly used for the exclusive benefit of the investment manager and its principal, and therefore sought an order that the company be treated as the subject matter of the proceedings on the ground that it is itself a victim of wrongdoing whether by way of breaches of fiduciary duty or breaches of contract. Further, it was contemplated that subject to the appointment of a liquidator or an interim receiver of the master accounts, leave would be sought for the liquidator or interim receiver to pursue claims against the directors, the investment manager and any other person or entity into which the companies' assets can be traced in order to recover them.

The anti-suit injunction

Following the commencement of the winding-up proceedings and prior to the hearing of the summons for directions and winding-up petitions, the Delaware partnerships and two of the Bahamian companies commenced proceedings in Delaware, which gave rise to the petitioner and others seeking an anti-suit injunction to restrain the foreign proceedings.

A further action was therefore filed on behalf of the petitioner and others that the defendants and their servants or agents be restrained from continuing or prosecuting, or assisting in the prosecution of, certain legal proceedings commenced in the Delaware Court of Chancery, insofar as such proceedings relate to and concerned the Bahamian companies currently subject to winding-up proceedings before the Supreme Court. The relief filed was also for an order that the defendants be restrained from commencing any further or other proceedings against the plaintiffs in relation to the relevant Bahamian companies in any jurisdiction other than the Bahamas: on the basis that contractual documents relevant to the US and Bahamian proceedings contain an exclusive jurisdiction clause in favour of the Bahamas; and for breach of the governing law clause by seeking to refer one of the contractual documents in dispute to the American Arbitration Association in accordance with the American Commercial Arbitration Rules and Mediation Procedure. Leave was also sought to issue and serve a concurrent writ of summons and notice thereof outside the jurisdiction on the Delaware partnerships.

The Supreme Court has the discretion to grant an anti-suit injunction in the context of insolvency proceedings, particularly where the ends of justice would require it, as noted in *Stichting Shell Pensioenfonds v Krys & Anor* [2014] UKPC. Further, section 192 of the CWUAA confers the power on the court to stay or restrain proceedings. A stay can be sought under that section at any time after the presentation of a winding-up petition and before a winding-up order has been made. The company or any creditor or contributory may:

- where any action or proceeding against the company, including a criminal proceeding, is pending in a summary court, the court, the Court of Appeal or the Privy Council, apply to the court in which the action or proceeding is pending for a stay of proceedings therein; and
- where any action or proceeding is pending against the company in a foreign court, apply to the court for an injunction to restrain further proceedings therein, and the court to which the application is made may, as the case may be, stay or restrain the proceedings accordingly on such terms as it thinks fit.

Recognition and assistance

In addition to its compulsory winding-up jurisdiction, the Bahamian court is able to offer assistance to distressed companies by giving recognition and effect within the Bahamas and pursuant to Bahamian law of foreign orders and restructuring arrangements through its cross-border insolvency regime. As explained above, a company is not permitted to forum shop in an effort to disadvantage its creditors; however, a company is entitled to request the assistance of the Bahamian court to give effect to a rehabilitative process aimed at keeping the company as a going concern, which would be beneficial to both stakeholders and creditors. In the Bahamas, foreign insolvency proceedings may be recognised if a foreign company has assets here and the foreign representative applies to the Bahamian court to be recognised. The Bahamian court is able to aid foreign companies seeking the recognition of an order appointing a receiver over assets outside of insolvency proceedings as well as assistance in the recognition of a foreign court-appointed officer. Recognition and assistance can be extended to 142 relevant foreign countries pursuant to the Foreign Proceedings (International Co-Operation) (Relevant Foreign Countries) Liquidation Rules 2016

Foreign court-appointed receiver

The procedure for recognition of a foreign representative is prescribed by Rule 4 of the Foreign Proceedings (International Cooperation Rules) 2012:[4]

4 '… (3) A petition under this rule shall state (a) particulars of the debtor's incorporation; (b) the nature and place of the debtor's business; (c) the court or other authority by which the foreign representative was appointed; (d) the powers and duties of the foreign representative under the law of the place of his appointment; and (e) the reasons for seeking a declaratory order.'

> *4 (1) An application by a foreign representative made under section 254(1) (a) of the Act for a declaratory order recognizing his right to act on behalf of a debtor shall be made by petition in accordance with RSC Order 9.*

A foreign representative is defined by section 253 of Part VIIA of the CWUAA as a trustee, liquidator or other official appointed in respect of a debtor for the purposes of a foreign proceeding.

Where the order appointing a foreign receiver is made outside a formal insolvency process, so that it does not fall within the terms of the Act, the appointment of a receiver by a foreign court in relation to a Bahamian company or a foreign company whose assets are located within the jurisdiction would be recognised on principles of common law.

At common law, a receiver appointed by a foreign court as an officer of that court in respect of property located in a foreign jurisdiction would only be able to exercise his or her powers in the foreign country to the extent that the foreign country recognises the validity and effect of the charge and the power of the receiver to act.

The Supreme Court in recognising the order appointing the receiver would not be enforcing the order; rather the Court would be recognising the receiver's authority in relation to the assets. The case of *KPMG Inc v Pogachar* and others[5] affirms the principle that there is a difference between the court recognising a judgment and giving effect to it. As a general principle, where a foreign court is regarded as having competent jurisdiction to have made an order appointing a receiver, comity would require recognition be afforded. But certain conditions must be satisfied before the Supreme Court would recognise an order appointing a foreign receiver as having competent jurisdiction.

On the hearing of an application for recognition, the parties would need to satisfy the Court that there was a sufficient connection that enabled the foreign jurisdiction to make the order. The Supreme Court will consider a foreign court as having competent jurisdiction if there is a 'sufficient connection' between the company in respect of which the receiver is appointed (the defendant) and the jurisdiction in which the foreign receiver was appointed to justify recognition of the foreign court's order. An example of a sufficient connection would be an appointment made by a court in the country in which the company is incorporated; however, there may be several circumstances where such a finding may be made.

The Supreme Court will require it to be established (i) that any relevant charge given by the debtor is enforceable within the Bahamas where the property is situated; (ii) that the foreign court was competent to make the appointment; and (iii) there is a sufficient connection between the defendant and the jurisdiction in which the foreign receiver was appointed to justify recognition of the foreign court's order as having effect outside the foreign jurisdiction.

Recognition in this sense is not based on the Reciprocal Enforcement of Judgments Act 1924 as it is arguable whether an order appointing a receiver is an enforceable judgment. Rather, in such cases, the power of the Bahamian court to recognise a foreign receiver is part

5 [2011] 3 BHS J. No. 109.

of the court's inherent jurisdiction and is based on well-recognised conflict-of-laws principles. The receiver would still, in seeking to take possession of assets, need to make the requisite applications within the jurisdiction and in accordance with Bahamian law. The order would recognise the receiver's authority to take steps towards obtaining possession, whether by agreement or otherwise, and title to the property.

An order recognising the appointment of a receiver would not be granted where to do so would be to give effect to a law that is contrary to Bahamian public policy and where there was no sufficient connection between the company and the jurisdiction of the district court. Thorne J, in *Chamberlain v Miss Boots (The)*[6] in considering recognition of a foreign receiver, stated that 'while a court must recognise every judgment it enforces, it need not enforce every judgment it recognises.' This is because, in certain circumstances, the court may refuse recognition where it amounts to enforcement of a negative obligation or an interlocutory order. Recognition is generally only granted in relation to final orders.

Therefore, if on the facts the appointment of the foreign receiver by the foreign court cannot surpass the 'sufficient connection' test, recognition will not be given.

As it relates to the procedure, such an application is made pursuant to section 21 of the Supreme Court Act or the inherent jurisdiction of the court by originating summons, and is supported by affidavit evidence including an affidavit of foreign law, which would serve to inform the court that the appointing court had the competent jurisdiction to appoint the receiver as well as to advise what the receiver's powers are pursuant to that order.

Recognition and provisional liquidations

The recognition of an order of a foreign court appointing a receiver does not protect the company from insolvency proceedings initiated within the Bahamas. The only way to protect a distressed company from insolvency proceedings and other claims while the company is being restructured is through the appointment of a provisional liquidator. The court may, at any time after the presentation of a winding-up petition but before the making of a winding-up order, appoint a liquidator provisionally. An application for the appointment of a provisional liquidator is made pursuant to section 199 of the CWUAA and may be made by a creditor or contributory of the company or any relevant regulator on the grounds that (i) there is a prima facie case for making a winding-up order; and (ii) the appointment of a provisional liquidator is necessary to prevent the dissipation or misuse of the company's assets, to prevent the oppression of minority shareholders, to prevent mismanagement or misconduct on the part of the company's directors, or it is in the public interest.[7]

An application for the appointment of a provisional liquidator may also be made by the company ex parte on the grounds that the company is or is likely to become unable to pay its debts within the meaning of section 188, and the company intends to present a compromise or arrangement to its creditors.[8] A provisional liquidator has the rights and powers of

6 [1992] BHS J. No. 8.

7 Section 199(2) of the CWUAA.

8 Section 199(3) of the CWUAA.

a liquidator to the extent necessary to maintain the value of the assets owned or managed by the company or to carry out the functions for which he or she was appointed and the court may limit the powers of a provisional liquidator in such manner and at such times as it considers fit.

The provisional liquidator would also have the power (with sanction of the court) to make any compromise or arrangement with creditors or persons claiming to be creditors or having or alleging themselves to have any claim (present or future, certain or contingent, ascertained or sounding only in damages) against the company or for which the company may be rendered liable. The liquidator also has the power to compromise, on such terms as may be agreed, all debts and liabilities capable of resulting in debts, and all claims (present or future, certain or contingent, ascertained or sounding only in damages) subsisting or supposed to subsist between the company and a contributory, or alleged contributory or other debtor, or person apprehending liability to the company. Finally, the liquidator would have the power to promote a scheme of arrangement pursuant to section 158 without sanction of the court.

In eight cases,[9] the Bahamian court appointed provisional liquidators over a group of companies that had sought recognition of Chapter 15 proceedings in Delaware within the Bahamas, which ultimately failed. In appointing the provisional liquidators, the court held that the appointment was necessary to preserve the assets of the companies and protect the assets from further dissipation by the directors of the companies for creditors. The court granted the provisional liquidators the power to promote schemes of arrangements and enter into protocols with creditors and stakeholders.

The appointment of a provisional liquidator in circumstances, where there are concurrent bankruptcy proceedings under way in another jurisdiction, would require an international protocol to be entered into with the approval of the Bahamian court and of the foreign court or authority. The purpose of an international protocol is to promote the orderly administration of the estate of a company in liquidation and the scope of such an arrangement includes the following: formulation and promotion of restructuring protocols, including schemes of arrangements; preservation of assets located outside of the Bahamas; and procedures for exchange of information between the official liquidator and the foreign officeholder

An application for the appointment of a provisional liquidator will protect the assets of a company from creditors and also permit applications to be made to other courts for assistance. It provides a means for restructuring procedures to be engaged while preserving assets located within the jurisdiction. The appointment of a provisional liquidator also triggers a

9 *Attorney-General of the Commonwealth of the Bahamas (In a representative capacity for and on behalf of the Government of the Commonwealth of The Bahamas, the Treasurer of the Commonwealth of The Bahamas, Bahamas Electricity Corporation, The National Insurance Board, The Water and Sewerage Corporation and the Gaming Board) v Baha Mar Ltd and others; The National Insurance Board of the Commonwealth of the Bahamas v Baha Mar Ltd; The Treasurer of the Commonwealth of the Bahamas v Baha Mar Land Holdings Ltd; The Treasurer of the Commonwealth of the Bahamas v Cable Beach Resorts Ltd; The Treasurer of the Commonwealth of the Bahamas v Baha Mar Properties Ltd; The Water & Sewerage Corporation v BMP Golf Ltd; The Treasurer of the Commonwealth of the Bahamas v BMP Three Ltd; The Gaming Board v Baha Mar Enterprises Ltd* [2015] 2 BHS J. No. 97.

moratorium on all claims, including claims for attachment and distress and execution, and protects the company from both existing and new legal proceedings.[10] Section 192 of the CWUAA provides that the court may, at any time after the presentation of a winding-up petition before an order, stay or restrain proceedings whether pending in a Bahamian court or a foreign court against the company. Once such an order is made, all proceedings against the company are stayed, which provides the distressed company with the time it needs to restructure and rehabilitate the company.

The appointment of a provisional liquidator by the Supreme Court in this manner is capable of recognition by a foreign court. The Supreme Court will also recognise the appointment of a provisional liquidator by a relevant foreign country in a foreign proceeding[11]. A foreign insolvency practitioner can also be appointed jointly with a Bahamian insolvency practitioner in insolvency proceedings in accordance with the Insolvency Practioner's Rules 2012.

Conclusion

The Bahamian legislature continues to examine its existing legislation for ways in which it can seek to promote judicial efficiency by amending and implementing new procedures in its insolvency regime. As the global economy continues to grow and foreign companies and investors increasingly face obstacles arising from the use of offshore structures, the need for cross-border insolvency proceedings and the use of protection afforded to investors are likely continue to increase. The Bahamas, through its dynamic legislation, has demonstrated that it is well equipped to handle complex commercial disputes when these cases arise.

10 Section 193 of the CWUAA.

11 Foreign Proceedings (International Co-operation) Relevant Foreign Countries Liquidation Rules 2016, http://laws.bahamas.gov.bs/cms/images/LEGISLATION/SUBORDINATE/2016/2016-0014/ForeignProceedingsInternationalCo-operationRelevantForeignCountriesLiquidationRules2016_1.pdf.

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Lennox Paton is a leading offshore, full-service commercial law firm providing services to clients in relation to Bahamian and British Virgin Islands law. As one of the Bahamas' largest law firms, it provides a comprehensive range of legal services including litigation; insolvency and restructuring; investment funds; trusts and foundations; banking and finance; real estate; resort development; corporate and commercial; private client; wealth management; and shipping.

A succession of long-term client relationships and landmark cases has earned the firm recognition as one of the top firms in the Bahamas. Its well-known expert attorneys are ranked among the best in the region, frequently in demand across the international conference circuit, in addition to fulfilling their duties in government and industry-appointed task forces, steering committees and statutory bodies.

The firm's insolvency and restructuring team represents a range of clients in relation to complex insolvency matters and they are widely acknowledged as a market leader in the region. The team are often involved in complex cross-border proceedings and are skilled in advising clients in relation to local insolvency laws or in relation to ancillary proceedings with a Bahamian component. The team act on behalf of receivers, creditors, administrative receivers, directors, trustees in bankruptcy, fiduciary claimants, liquidators and companies in connection with insolvency issues, including securing assets in the Bahamas and the British Virgin Islands.

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Bermuda

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In summary

This chapter discusses the defining features of Bermuda's insolvency landscape and the primary insolvency and rescue procedures available under Bermuda law, including compulsory liquidations and schemes of arrangements. The restructuring of Noble Group Limited is presented as a case-study, to illustrate the use of provisional liquidation to facilitate a restructuring via a scheme of arrangement. The chapter also reviews the role of the Bermuda court in cross-border insolvencies and the creditor-friendly nature of the insolvency regime in Bermuda.

Discussion points

- The importance of provisional liquidation
- The benefit of a statutory stay
- A creditor-friendly jurisdiction
- Cross-border cooperation and its limits

Referenced in this article

- The Companies Act 1981, Part XIII
- The Companies (Winding Up) Rules 1982
- The Bankruptcy Act 1989
- The Segregated Accounts Companies Act 2000
- The Supreme Court of Bermuda
- *Z-OBEE Holdings Ltd* [2017] Bda LR 19
- Noble Group Limited restructuring

Legal framework

Bermuda is an overseas territory of the United Kingdom and its legal system is based on the English common law comprising statute and case law. Bermuda has developed its own body of common law and statutes and this has been influenced by several jurisdictions including England, Canada, Australia and New Zealand. Decisions of the English Courts are not binding on a Bermuda Court, although they are highly persuasive. The decisions of the Privy Council, however, are generally binding on the Bermuda courts, unless they are based on a reference from a jurisdiction with considerably different statutory provisions and policies. The Privy Council is Bermuda's highest appellate court and sits in London.

Bermuda's insolvency landscape

Bermuda insolvency law consists of statute and common law. The principal statutory provisions[1] governing corporate insolvency and restructuring are contained in Part XIII of the Companies Act 1981 (Companies Act) and are supported by the Companies (Winding-Up) Rules 1982 (Winding-Up Rules). The Companies Act is based on the English Companies Act 1948 and the Companies Winding-Up Rules are based on the English Companies (Winding-Up) Rules 1949.[2] No substantive changes have been made to Part XIII of the Companies Act and the Winding-Up Rules since they were enacted, although there have been minor amendments.

At the heart of Bermuda insolvency law is the principle of *pari passu* treatment of unsecured creditors (ie, where the company does not have sufficient assets to satisfy its debts to unsecured creditors, each unsecured creditor would receive an equal distribution on a rateable basis according to the quantum of their claim).[3] Secured creditors are unaffected by insolvency proceedings in Bermuda and may enforce their security in accordance with the terms of the governing security instrument[4] (although they have standing to present winding-up petitions).

A key feature of Bermuda insolvency law is that the Companies Act provides the ability to challenge certain transactions executed by insolvent companies through avoidance or clawback provisions. This includes the avoidance of preferential payments to creditors and transactions at an undervalue. The Companies Act also provides remedies for fraudulent trading and dispositions of company property after the commencement of the winding-up.

1 Certain provisions within the Bankruptcy Act 1989 apply to companies under section 235 of the Companies Act.

2 English insolvency law has been reformed significantly since the English Companies Act 1948 and the Companies (Winding-Up) Rules 1949.

3 In certain circumstances, employees may have a preferential status.

4 The stay of proceedings that occurs when a winding-up order is made does not prevent secured creditors from exercising their rights under validly created security.

Corporate insolvency and rescue procedures

The primary insolvency and rescue procedures available under Bermuda Law are:

- Liquidation under the supervision of the court, commonly referenced as 'compulsory liquidation' or 'compulsory winding-up';
- provisional liquidation for the purpose of restructuring; and
- schemes of arrangement.

Bankruptcy procedures are relevant in the context of insolvent funds and individual insolvencies. The remedy of receivership is an important mechanism used when a segregated accounts company is insolvent.

Compulsory liquidation

Typically, a creditor seeking to place a debtor company into liquidation in Bermuda will apply to the court seeking such relief on the grounds the company is unable to pay its debts or that it is just and equitable for the company to be wound up. Compulsory winding-up proceedings can be commenced by any one or more of the following:

- the company itself;
- creditors, including any contingent or prospective creditors;[5]
- contributories, subject to certain restrictions; and
- regulator (if applicable).

The mode of beginning winding-up proceedings is by filing a winding-up petition with the Supreme Court of Bermuda, which is supported by a standard form affidavit verifying the contents of the petition. Once the court fixes a date for the hearing of the petition, the petition must be served on the company at its registered office. Before the hearing of the petition, the petitioner must obtain a certificate of compliance from the registrar of the Supreme Court certifying that the petition is ready for hearing because it has been properly filed, served and advertised in an appointed newspaper.

Those intending to appear at the hearing of the petition, including those who wish to oppose the petition, are required to provide advance written notice to the petitioner within a prescribed time frame, failing which they require special leave of the court to appear at the hearing.

On hearing a winding-up petition, the court may grant, dismiss or adjourn the petition, or make any other order it thinks fit. It is unlikely that the court would grant a stay of winding-up proceedings, except in exceptional circumstances. However, the court may adjourn a winding-up petition in order to facilitate a proposed restructuring by the company with the assistance of a court-appointed insolvency practitioner known as a 'provisional liquidator'.

5 However, the court will not give a hearing to a winding-up petition presented by a contingent or prospective creditor until security for costs has been given and a prima facie case for winding up has been established.

On the making of a winding-up order, the company's operations come to an end and the control of the company is taken from the directors and is placed in the hands of a court-appointed liquidator.[6] Liquidators are equipped with a wide array of powers to ensure that the company adheres to a statutory process contained in the Winding-Up Rules. This process is intended to promote a systematic and orderly winding down of the company's affairs.

Provisional liquidation

Provisional liquidation occurs in two scenarios, being:

- where the Bermuda court appoints an officer (typically an insolvency practitioner) with clearly defined powers that may be used where there is a prospect of 'rescuing' an insolvent company through restructuring without the displacement of all of the board's executive functions; or
- where it is necessary for the court to appoint an officer to protect and prevent a dissipation of the company's assets in the intervening period between the filing of a petition and the making of a winding-up order.

The former type of provisional liquidation is a distinguishing feature of Bermuda's restructuring landscape. Accordingly, where a company is insolvent, rather than making a winding-up order immediately upon hearing the petition, the Bermuda court often appoints provisional liquidators with certain, limited powers, known as 'light' or 'soft-touch' powers.[7]

In a light-touch liquidation, a company may continue its business operations as usual, pending the implementation of a restructuring plan. This would normally occur where the court is satisfied that a restructuring will produce a better result than a winding up for creditors. As explained by Kawaley CJ in *Z-OBEE Holdings Ltd* (2017) Bda LR 19:

> *This provision has for almost 20 years been construed as empowering this Court to appoint a provisional liquidator with powers limited to implementing a restructuring rather than displacing the management altogether pending a winding-up of the respondent company.*

The Bermuda court has used provisional liquidation as a tool to restructure the affairs of a company, preserve value in a business and provide a platform for distressed companies to recover – which together promotes the sustainability and success of cross-border business.

The benefits of this approach include the stay of proceedings against the company triggered by the appointment of provisional liquidators and independent oversight of the restructuring by court officers focused on protecting creditor interests.

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6 Technically, the liquidator appointed on the making of a winding-up order is a 'provisional' liquidator until his or her appointment is confirmed by a majority vote at the first meeting of creditors and contributories – which usually takes place within a month of the making of the order. Once a liquidator's appointment is confirmed, he or she is known as a permanent liquidator.

7 Authority for provisional liquidators with 'light touch' powers is not found in the Companies Act or any other legislation, but rather in Bermuda common law.

Schemes of arrangement

A scheme of arrangement is the only court-supervised reorganisation procedure in Bermuda, provided for in sections 99 and 100 of the Companies Act. A scheme of arrangement may be initiated by the company, any member or creditor of the company or, where applicable, a liquidator who has been appointed in relation to the company. A proposed scheme must represent a compromise or arrangement between the company and its creditors or members, or any classes thereof.

Proceedings are started by applying to the Bermuda court for directions to convene meetings with the various classes of creditors or shareholders who will be affected by the scheme's proposals. Once the meetings have been convened, a further application is made to the court to approve or 'sanction' the scheme.

Classes of creditors are determined by the requirement for a class to be confined to those persons whose rights (as affected by the proposed scheme) are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

For a scheme to be presented to the Bermuda courts for sanction, a majority in number representing 5 per cent in value of the creditors or members present and voting either in person or by proxy at each creditors' or members' class meeting, as the case may be, must approve the scheme.

Cram-up or cramdown (as those terms are generally understood in reorganisation proceedings) of a scheme of arrangement on to any dissenting class of creditors or members is not permitted in a Bermuda scheme of arrangement. To the extent that any single class of affected creditors or members fails to approve the scheme of arrangement by the requisite majority, the scheme will fail in its totality.

Expedited restructurings

The Companies Act does not provide for an expedited reorganisation, such as a reorganisation by way of a pre-pack arrangement. However, as a matter of practice, a reorganisation may be informally negotiated with a liquidator prior to his or her appointment on the informal understanding that the liquidator will approve the pre-negotiated arrangement once appointed. This type of informal arrangement will have similar effect to a pre-package deal but the details of the arrangement will be bespoke to the particular circumstances of the case.

Receivership

Receivers are generally appointed by secured creditors pursuant to the terms of a security agreement. The function of the receiver is to realise the relevant secured assets of the company for the benefit of the security-holder. Assets of a company that have been validly secured as security for a company's indebtedness are exempted from the claims of creditors in insolvency. On completion of the receivership, therefore, there can be a winding up of the assets not realised by the receiver for the benefit of the company's unsecured creditors.

There is a separate insolvency regime that applies to segregated accounts companies incorporated in Bermuda under the Segregated Accounts Companies Act 2000 (sometimes referred to as protected cell companies or segregated portfolio companies in other jurisdictions). This regime provides for the appointment of receivers over the segregated accounts (or cells) of the segregated accounts company which are unable to meet their liabilities as they fall due. A liquidator may be appointed over a segregated account company's general account if it is insolvent. There are relatively few statutory rules underpinning this regime when compared to the winding-up regime that applies to limited liability companies incorporated in Bermuda. It is thought that the Bermuda court would model its approach to the winding up of a segregated accounts company on the court's established practice in relation to limited liability companies.

Bankruptcy

Corporate insolvency generally refers to the winding-up regime under Part XIII of the Companies Act and the Winding-Up Rules. Bankruptcy is a term that only applies to individual insolvency and limited partnerships, the latter being the corporate vehicle regularly used for investment funds.

Observations

Creditor-friendly jurisdiction

On the surface, the statutory rules governing the winding up of companies are not clearly creditor friendly. The regime is ostensibly designed to ensure that insolvent companies come to an end by having liquidators appointed to realise the company's assets, in order to satisfy creditors' claims before the Bermuda court dissolves whatever remains of the company. However, in practice, the Bermuda court is adept at applying the statutory regime with enough flexibility to achieve creditor-friendly results. In fact, a prominent characteristic of the insolvency regime is the Bermuda court's development of a rescue culture. When a company is insolvent, rather than making a winding-up order immediately upon the winding-up petition, the Bermuda court often appoints provisional liquidators on a light-touch basis, allowing the company to continue its business as usual (under the supervision of court appoint office holders) pending the implementation of a restructuring plan through a scheme of arrangement.

Another defining feature of the insolvency landscape is the Bermuda court's willingness to work in tandem with, and lend assistance to, foreign courts and be receptive to companies having interests in other jurisdictions where there is a substantial international creditor or asset base. By way of illustration, in 2017, the Bermuda Supreme Court and the Supreme Court of Singapore signed a Memorandum of Understanding of References of Questions of Foreign Law in order to facilitate legal cooperation between the two jurisdictions.

Hallmark of provisional liquidation – Noble Group Limited

The value of provisional liquidation was demonstrated in the widely publicised restructuring of Noble Group Limited in 2018. Noble Group was incorporated in Bermuda and listed on the mainboard of the Singapore Exchange. It was the ultimate holding company of a group of companies that was one of the world's largest commodity traders, with hubs in London, Hong Kong and Singapore. The group managed a portfolio of global supply chains that involved marketing, processing, financing and transporting across the world. The restructuring was highly complicated owing to the very wide range of creditors involved and the global scale of the group's business.

Noble Group experienced grave financial difficulties because of the industry-wide decline in commodity prices between 2014 and 2016. Noble Group's pre-restructuring debt exceeded US$3 billion dollars. To avoid liquidation, the company's directors pursued a financial restructuring based on a debt-for-equity swap and provided for the transfer of Noble Group's assets to newly incorporated subsidiaries of a newly incorporated holding company, New Noble. Noble Group itself was to be dissolved. Scheme creditors were to be issued with new debt instruments and 70 per cent equity in the new group. The remaining equity was to be apportioned, with 20 per cent issued to existing shareholders and 10 per cent issued to existing management. One of the main goals of the scheme was to provide the new group with access to new hedging and trade finance facilities (US$800 million). These facilities were to be provided by a finance creditor, but also by scheme creditors who chose to guarantee the facility in exchange for senior debt instruments.

The company originally sought to achieve the restructuring solely by entering into parallel schemes of arrangement with its creditors (which were governed by both English and Bermuda law processes). Prior to presenting the English scheme of arrangement, which was regarded as the 'lead' scheme, Noble Group took steps to shift its centre of main interests from Hong Kong to England, including by relocating its main office to London from Hong Kong.

The English and Bermuda schemes of arrangement were approved by an overwhelming majority of scheme creditors and were sanctioned by the courts in both jurisdictions. The English scheme was sanctioned on 12 November 2018 and the Bermuda scheme was sanctioned two days later. The US Bankruptcy Court granted recognition of the scheme in the United States, via Chapter 15 of the US Bankruptcy Code, on 15 November 2018. Thereafter, all that remained was for the company's directors to implement the scheme.

Following sanction of the schemes, however, the Singaporean authorities blocked the transfer of Noble Group's listing on the Singapore Exchange to New Noble because of an ongoing investigation of the company and one of its subsidiaries. It was previously anticipated that Noble Group's listing status in Singapore would be transferred to New Noble and the company's directors had received prior shareholder approvals to pursue the restructuring on this basis. For various reasons – importantly, the stance taken by the Singaporean authorities – the directors were prevented from implementing the scheme in the manner contemplated.

Noble Group's directors consequently pursued its restructuring using liquidation on a light-touch basis. On 14 December 2018, the Bermuda court appointed a provisional liquidator with light-touch powers over Noble Group. The significance of this appointment lies in the fact that the provisional liquidator was not subject to the same constraints faced by the company's directors. His mandate would be solely guided by the best interest of the creditors, while at the same time being subject to the supervision of the court and having the benefit of a stay of proceedings against the company.[8]

In the context of Noble Group, the provisional liquidator was granted sufficient latitude to implement the transfer of the company's assets to the New Noble, provided that the scheme creditors were not prejudiced, even if that meant that the New Noble would no longer have a listing on the Singapore Stock Exchange as previously envisaged. Today, the New Noble is fully operational and the restructuring was a success. Had the Bermuda court not appointed a provisional liquidator, the company would have undergone a compulsory liquidation, its business would have come to an end and creditors would have received a significantly smaller dividend.

Cross-border support

There are two main types of cases involving cross-border support that frequently arise in Bermuda. First, there are cases in which a winding-up proceeding is commenced in Bermuda to run parallel to, or in tandem with, an insolvency proceeding taking place elsewhere for the purpose of restructuring a Bermuda-registered company. Specifically, there have been a number of cases where Bermuda companies have been the subject of Chapter 11 proceedings in the United States, in which the Bermuda court has appointed provisional liquidators with light-touch powers to supervise the directors in the conduct of the Chapter 11 proceedings and to report to the Bermuda court. The Bermuda court will generally defer to the Chapter 11 proceedings and give effect to the Chapter 11 plan or reorganisation. As mentioned above, the advantages of this approach include independent oversight of the restructuring by court officers (ie, the provisional liquidators) focused on protecting creditors' interests and achieving a stay of proceedings against the company which is triggered by the appointment of provisional liquidators.

Second, there are cases in which a foreign office holder (eg, liquidator) applies to the Bermuda court for relief to assist with a liquidation taking place outside Bermuda, for instance, by asking the Bermuda court to order Bermuda entities to produce information or orders compelling individuals in Bermuda to provide witness evidence. The Bermuda court may exercise its common law power to assist in these cases, and has demonstrated a general willingness to do so, provided that the foreign office holder could obtain the same relief from the court in the country where the liquidation is taking place.

In relation to the topic of cross-border support, the Bermuda court does not have jurisdiction to wind up overseas companies, save for certain statutory exceptions. In the context of a group of companies, this restriction means that the Bermuda court lacks jurisdiction

8 The stay arises upon the appointment of a provisional liquidator, under section 167(3) of the Companies Act.

to wind up a multinational group of companies, as it is not possible to obtain an ancillary winding-up order from the Bermuda court in respect of a company within the corporate group that is domiciled outside Bermuda.

On the other hand, where the Bermuda court has appointed liquidators to wind up a Bermuda company, the liquidators may commence ancillary insolvency proceedings in other jurisdictions that permit ancillary proceedings (eg, in England or Hong Kong).

Although there are no formal protocols or agreements for coordinating the interaction between the Bermuda court and foreign courts in cross-border insolvencies, the Supreme Court of Bermuda has issued practice directions relating to cross-border insolvencies – most recently, the Guidelines for Communication and Cooperation between Courts in Cross-Border Insolvency Matters dated 9 March 2017 (which is modelled on the draft guidelines adopted by the Judicial Insolvency Network in October 2016).

Looking ahead

Although Bermuda has developed a rescue culture to assist insolvent companies (using the mechanism of provisional liquidation), this is not yet reflected in the applicable statutes. As it currently stands, the principles and rules governing provisional liquidation – being a central feature of the Bermuda restructuring landscape – derive from case law. To date, no attempt has been made to formalise the rules, procedures and scope of provisional liquidation in a statutory format adopted by other jurisdictions.

By contrast, the Canadian Bankruptcy and Insolvency Act (BIA) makes provision for the concept of a 'proposal trustee', being an officer of the court, to assist an insolvent company with restructuring its affairs by presenting a 'proposal' to its creditors. The BIA sets out the procedure, requirements, scope and timelines to achieve a successful restructuring and has encouraged other jurisdictions (including Barbados and Saint Vincent and the Grenadines) to follow suit. Similarly, England's Insolvency Act created the concept of administration proceedings which provides for the appointment of an administrator to manage the affairs of a company for the purposes of its survival.

Clarity and certainty might be added to Bermuda's insolvency landscape by enacting even a rudimentary statutory framework. While the courts have allowed provisional liquidation to evolve into a malleable tool which plays a vital role in cross-border restructurings, it is anticipated that legislators may, in due course, start defining the boundaries and scope of provisional liquidation in a clear and systematic manner to make the tool even more versatile and effective.

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In his Bermuda role, he leads the Bermuda insolvency and restructuring team and the regulatory disputes team.

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He specialises in the areas of commercial litigation, restructuring, insolvency litigation, funds litigation and regulatory matters. He has represented clients in a wide variety of commercial disputes in Bermuda, England, the United States, Europe and Asia. He is also frequently involved in major arbitrations in Bermuda and internationally in both commercial, and insurance and reinsurance matters. Prior to joining Appleby, John practised in London and Hong Kong with a major international firm. John has been admitted in Bermuda, England, New York, Hong Kong, British Virgin Islands and British Columbia.

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He was appointed as an assistant justice of the Supreme Court of Bermuda for a one-year term on 30 July 2012 to sit in civil and commercial matters. John has also sat as an acting puisne judge on an ad hoc basis in the past few years.

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Lalita Vaswani is a senior associate in Appleby's dispute resolution department. She has a background in commercial and corporate litigation with a focus on restructuring and insolvency. Lalita completed her law degree at Warwick University and her LLM at the London School of Economics. She practised for seven years at a top-tier firm in Barbados and was admitted in Barbados and the Eastern Caribbean. During her tenure in Barbados, she played a pivotal role in several high-profile cross-border bankruptcy and insolvency matters, including one of the largest insolvency matters in the history of the Caribbean.

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Sam Riihiluoma is an associate in Appleby's dispute resolution department. He has developed an expertise and achieved notable successes in a number of areas of civil and commercial litigation. Sam regularly advises and represents liquidators in winding-up proceedings of Bermuda companies for liquidation and for restructuring purposes. He also has a proven track record in regulatory matters, contractual disputes and professional liability claims. His depth of knowledge and analytical skills mean he is well equipped to give sound advice on the substantive merits and procedural aspects of any claim or defence.

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In summary

This chapter presents a general framework of the Brazilian Bankruptcy Law (Law 11,101 of 2005), including a detailed overview of reorganisation and liquidation proceedings. It also discusses possible upcoming changes in Law 11,101 that are still under discussion within Brazilian Congress.

Discussion points

- An overview of the Brazilian Bankruptcy Law
- Law 11,101 and its improvements over previous legislation (Decree-Law 7.661)
- A brief description of reorganisation proceedings in Brazil
- Bankruptcy liquidation in Brazil
- Possible upcoming changes in Law 11,101 and its impacts on the current framework

Referenced in this article

- Brazilian Bankruptcy Law
- Brazilian Congress
- Operation Car Wash
- 2018 Bill
- UNCITRAL Model Law on Cross-Border Insolvency
- National Treasury Department

Introduction

The current Brazilian legislation on corporate insolvency law entered into force in 2005 with Federal Law 11,101. This legislation represented a long-anticipated change in the mindset regarding the previous bankruptcy law (Decree-Law 7.661), which had been enacted in 1945 and was no longer on par with the current social and economic goals of insolvency law.

Incorporating many of the most modern tendencies concerning international insolvency law, and heavily based on some of the procedures set forth by the American Bankruptcy Code, Law 11,101 incorporated principles of the World Bank and the IMF, and its main purpose was to create an efficient insolvency system and to allow negotiations between debtor and creditors to take place, with the primary goal of preserving viable economic activities while allowing for a more efficient credit recovery.

The consensus is that Law 11,101 represented a huge improvement over the 60-year-old legislation that preceded it. However, since its enactment, it has been heavily criticised as it has been shown to be inefficient for credit recovery and the reorganisation of businesses. In December 2016, the government designated a workgroup to propose amendments to the provisions of Law 11,101 and revamp corporate insolvency proceedings in Brazil. The results of this workgroup were consolidated and presented as a Bill to Brazilian Congress in May 2018. Although the Bill encompasses most of the changes proposed by the workgroup, it was subject to the relevant influence of tax authorities during its proposition, and many of the proposed changes are considered to be highly controversial, especially in regard to the treatment of tax claims and the rights of the treasury in insolvency proceedings.

The 2018 Bill is currently under discussion within the Brazilian Congress, and an updated version of it may be proposed soon. The current estimate is that a global reform of the Law 11,101 may be approved by the end of 2019.

However, regardless of the specific changes that will be approved, at its core, Law 11,101 will remain the same, especially when it comes to the different procedures it establishes. Law 11,101 provides for three different court proceedings: judicial reorganisation, expedited reorganisation and bankruptcy liquidation. Only debtors engaged in business activities are subject to those proceedings. The insolvency of consumers and civil associations, as well as other entities, such as financial institutions and cooperatives, are the object of other statutes.

Reorganisation

Reorganisation proceedings are court-supervised arrangements between a debtor and its creditors. Debtors under financial distress are allowed to file voluntary petitions for judicial reorganisation; creditors are not entitled to do so. It has become common, though not specifically provided by law, that groups of debtor companies file joint petitions for reorganisation, even in substantive consolidation, and such requests have been widely accepted by the courts.

Filing

A debtor's request for judicial reorganisation must include, inter alia, a statement of the causes of its financial distress; financial statements for the previous three years of operations; the list of creditors and claims, and the list of employees and their claims. Among other conditions, Law 11,101 provides that to qualify to file for judicial reorganisation, the debtor must, at the time the application is made, have been doing business regularly for longer than two years.

All claims existing at the time of the filing, even if not yet due, are affected by the reorganisation proceeding, with some exceptions, such as tax claims, advances on foreign exchange (ACCs) and claims secured by chattel mortgages, or fiduciary assignments. Claims incurred after the filing are also not affected by the reorganisation proceeding and may be paid by the debtor or enforced by the relevant creditor. If the eligibility requirements are met, the court will issue a decision allowing the commencement of the proceedings, appointing a judicial administrator, to monitor the debtor's activities, and ordering a stay of all enforcement actions against the debtor for a period of 180 days. Such period is usually extended by the courts upon the request of the debtor, in many instances with the consent of the creditors.

A reorganisation is a debtor-in-possession proceeding, and management remains in control of the assets and the activity, under the supervision of the judicial administrator (and of the creditors' committee, should there be one). However, the debtor is not allowed to sell its fixed assets unless such sale is authorised by the court or by a court-approved plan of reorganisation.

Plan of reorganisation

The debtor shall propose a plan of reorganisation within 60 days following the commencement decision. The plan provides for the means by which the debtor intends to reorganise its business and satisfy the affected claims, and must also include an appraisal of the assets and a financial assessment confirming that the plan is viable. It has become common for plans to provide for payment extensions, haircuts, debt-to-equity conversions, mergers and acquisitions, sales of assets, issuance of new debt and so on. Although labour creditors are included in the reorganisation proceeding, Law 11,101 requires that the plan shall not provide for a term longer than one year for the payment of labour-related claims or occupational accident claims that are due by the filing date.

The plan may provide for the sale, free and clear, of branches or isolated production units (also called UPI's) of the debtor. In such cases, the purchaser acquires the branches or isolated production units, as the case may be, without being held liable for the debtor's debts and contingencies, including tax and labour liabilities. In addition to being provided for in the plan, courts usually require that the sale be carried out by means of a judicial auction or similar competitive procedure. It has become common practice for investors to acquire assets such as isolated production units under a judicial reorganisation proceeding to avoid successor liability, especially with respect to labour and tax debts and contingencies (which, under Brazilian law, are prone to spill over to equity holders). The non-succession rule does not apply if the acquirer of the branch or production unit is:

- an equity holder of the debtor;
- an entity controlled by the debtor;

- a direct or collateral relative up to the fourth degree, by blood or affinity, of the debtor or of a shareholder of the debtor; or
- an agent of the debtor.

Although tax claims may not be affected by the plan, legislation enacted in November 2014 allowed companies under reorganisation to apply for a tax instalment plan to pay federal tax debts in 84 monthly instalments. The Bill proposed to Brazilian Congress in 2018 aims to expand the number of instalments to 120 and allows companies to offset taxes derived from any haircut granted by creditors against accumulated tax losses. Although the system proposed by the 2018 Bill is more flexible than the system set forth by the 2014 legislation, both are considered to be insufficient to deal with the tax claims of insolvent companies, and are also restricted to federal taxes (not dealing with state and municipal taxes).

Voting and confirmation of the plan

After the plan is submitted to court, creditors may file objections thereto. If no objections are filed, and the plan is not otherwise unlawful, the court will confirm the plan without a creditor voting. If, however, one or more creditors object, which happens in the vast majority of cases, the court will call a creditors' general meeting to consider and vote on the plan. The plan may be modified or amended at any time before or at the creditors' meeting, subject to the debtor's consent, but it may not be modified in a manner that unfairly discriminates against creditors not attending the meeting.

For the purposes of voting on the plan, creditors are currently divided into four classes:

- holders of labour claims;
- holders of secured claims, up to the limit of the collateral;
- holders of unsecured claims; and
- creditors that qualify as micro and small companies.

Creditors whose claims are unimpaired by the plan shall not have the right to vote. Related parties, such as equity holders of the debtor, are also not allowed to vote. It is worth noting that the 2018 Bill aims to change this system of fixed statutory classes, establishing that the classes of creditors shall be divided and organised by the reorganisation plan, based on criteria of similarity. However, until the Bill is approved, the regular system of four fixed classes of creditors remains applicable.

In order to be considered regularly approved by the creditors' general meeting, the plan must have a favourable vote of:

- more than 50 per cent of the claims, in number, in the class of labour claims;
- more than 50 per cent of the claims, in both number and amount, in the class of secured claims;
- more than 50 per cent of the claims, in both number and amount, in the class of unsecured claims; and
- more than 50 per cent of the claims, in number, in the class of claims held by micro and small companies.

If the plan is approved by the required majorities, it will be confirmed by the court and therefore becomes binding on the debtor company and on all affected creditors. If the required majorities are not met, the court may still confirm the plan if there is an alternative quorum. Such cramdown confirmation requires the following cumulative requirements:

- a favourable vote of holders of a simple majority in amount of all claims affected by the plan;
- the approval of the plan in at least two of the classes (or one, if there are only two classes), according to the same criteria used for a regular approval;
- a favourable vote of at least one-third of the creditors in the dissenting class; and
- absence of discrimination among the creditors of the dissenting class.

If cramdown confirmation is not possible, the debtor will be declared bankrupt and its assets will be sold in a liquidation proceeding.

Majorities are calculated based on the creditors attending the general meeting of creditors to which the plan is submitted. Creditors not attending the meeting, as well as unimpaired creditors and related parties, as mentioned above, are disregarded. In addition, creditors who abstain from voting are also not considered for calculating the required majority.

After court confirmation, the debtor remains under judicial reorganisation for up to two years following court confirmation of the plan to allow the court to monitor whether the plan obligations that become due during such period have been duly complied with. However, it is common for debtors to remain under judicial reorganisation until the court rules on all challenges to the list of creditors and claims.

If, during this period, the debtor breaches the plan, Law 11,101 provides that the court shall convert the reorganisation into a liquidation in bankruptcy. However, and although it is not provided for in Law 11,101, it has become common practice for the company to submit amendments of the restructuring plan to the general creditors' meeting. If the amendments are approved at the meeting, such amendments become valid and binding on the debtor company and its creditors.

According to its last official version, the 2018 Bill proposes to allow the court to waive the two-year oversight period in some cases. There are already some precedents and works by commentators that defend the possibility of waiver of such period as long as the creditors agree with it or it is set forth in the approved plan.

Expedited reorganisation

The purpose of expedited reorganisation proceedings is to seek court confirmation of pre-negotiated and approved arrangements between a debtor and one or more classes of creditors, or groups of creditors with similar economic interests. After obtaining the approval of the plan by such creditors, the debtor files a proceeding seeking court confirmation. If at least 60 per cent of the claims belonging to each of the impaired classes or groups approve the plan, it becomes binding on all the creditors of each classes or groups upon confirmation.

Any claim, secured or unsecured, matured or not, may be subject to a pre-packaged reorganisation plan, with the exception of labour claims and of all the other claims not affected by a court-supervised reorganisation (such as tax claims).

After the debtor obtains the relevant approvals and files a voluntary petition for expedited reorganisation (again, creditors are not allowed to do so), and even though it is not directly provided by Law 11,101, the court usually orders a stay of 180 days during which holders of impaired claims cannot perform enforcement measures. The court also orders the publication of a notice allowing any dissenting creditor to file objections to the plan within 30 days. After the expiration of this deadline, the court will confirm the plan if the quorum requirements are met and if the plan does not infringe the law.

Although expedited reorganisations are fast-track proceedings, and less complicated and value destructive for the debtor company, they are still not widely used in Brazil.

Bankruptcy liquidation proceeding

Bankruptcy liquidations are court-supervised proceedings in which the assets of the debtor are sold with the purpose of paying its creditors according to the priority rule set forth by Law 11,101. Although they are perceived to be inefficient and value destructive, they are also the most common insolvency proceedings in Brazil.

Commencement and declaration

Voluntary bankruptcy proceedings (ie, bankruptcy proceedings filed by the debtor) are commenced by the applicant by filing a petition with the court, stating the reasons for the impossibility of the company to carry on its business, accompanied by certain documents, as provided by Law 11,101. However, voluntary petitions for bankruptcy liquidation are rare. In the majority of cases, creditors file involuntary bankruptcy petitions, and are allowed to do so if the debtor fails to pay a claim in the amount of at least 40 minimum wages at the due date.

Once bankruptcy is declared, the court will appoint a judicial administrator, who will manage the bankrupt estate until its liquidation is completed. The management of the debtor company is removed and the judicial administrator takes over the administration of the estate. Among other effects, the decision declaring the debtor bankrupt also forbids any act of disposal or encumbrance of the debtor's assets without prior authorisation by the bankruptcy court and the creditors' committee, should there be one.

The bankrupt estate may continue to operate (managed by the judicial administrator) during the bankruptcy proceeding so that the business may be sold as a going concern. However, in the vast majority of cases, the bankrupt company ceases to operate, its facilities are locked down by the judicial administrator, and the assets are collected to be sold under a judicial auction.

In some circumstances, the court may disregard the legal entity and extend the effects of the bankruptcy proceeding to the equity holders or administrators of the debtor company, or even to other entities considered to be part of the same corporate or economic group of the debtor company. Although the extension of the effects of the bankruptcy to third parties is an exception applicable to cases in which there is fraud or commingling of assets, there is a risk associated with the fact that some courts may apply such measure in a broader manner. As a result, there is a risk, though it may be remote, that the effects of a bankruptcy proceeding is extended to equity holders, administrators or other entities belonging to the same corporate or economic group.

Classification of claims

In a procedure similar to the one found in a reorganisation proceeding for verification of claims, a general list of creditors will be prepared by the judicial administrator and creditors may challenge such list in court according to Law 11,101.

The claims will be classified according to the rules of Law 11,101, and creditors will be paid pursuant to a waterfall, as follows:

- labour-related claims, limited to 150 monthly minimum wages per creditor, and occupational health claims;
- secured claims (ie, claims secured by a mortgage or pledge) up to the limit of the value of the collateral;
- tax claims, regardless of their nature and date on which they arose, except for tax fines;
- special privileged claims, including claims held by micro and small enterprises;
- general privileged claims;
- unsecured claims, including labour claims exceeding 150 minimum wages, and claims exceeding the value of the collateral in case of secured claims;
- contractual penalties and fines for breach of criminal or administrative law, including tax-related fines; and
- subordinated claims, such as those stipulated by law or contract, as well as the claims held by the debtor's equity holders or officers who are not employees of the debtor.

Certain claims, as defined in article 84 of the insolvency law, shall take priority over all claims listed above, such as fees payable to the judicial administrator and his or her assistants, labour-related claims or occupational health accidents referring to services rendered after the bankruptcy decree and amounts lent by creditors in favour of the estate.

In addition, there are claims that are not affected by a bankruptcy proceeding and that may be enforced by the creditor, such as claims deriving from ACCs, claims secured by chattel mortgages and fiduciary assignments and claims deriving from certain leasing transactions.

Sale of assets

The liquidation of the estate should be effected in one of the following forms, in order of preference as set forth in Law 11,101:

- disposal of the business, with the block sale of its establishments;
- disposal of its branches or manufacturing plants as separate units;
- disposal in block of the assets constituting each of the debtors establishments; or
- disposal of the assets considered individually.

In the majority of the cases – and even though the law pushes for the sale of assets as a going concern – they are sold piecemeal.

The general rule for the sale and liquidation of assets within bankruptcy proceedings, as contemplated by Law 11,101, is that the court will order a public auction of the assets, preceded by the publication of a notice in a widely circulated newspaper. However, the court may authorise or the creditors' meeting may approve (by a voting of creditors holding two-thirds of the claims) any alternative form of sale.

The assets that are disposed of are free and clear of any encumbrance, the successful bidder not being held liable for the debtor's past obligations and contingencies, including tax and labour-related obligations and liabilities, and occupational accident obligations, except when the successful bidder is a shareholder in the bankrupt company or a legal entity controlled by the bankrupt debtor; a direct or collateral relative up to the fourth degree, by blood or affinity, of the debtor or of a shareholder in the bankrupt company; or identified as an agent of the debtor for the purpose of defrauding creditors.

Emergence from bankruptcy and discharge

Upon the realisation of the estate's assets and distribution of the proceeds among the creditors, the judicial administrator must submit his or her accounts to the court. After the judicial administrator's accounts have been approved, he or she must submit the final report on the proceedings, stating the value of the assets and of the proceeds of their realisation, the value of liabilities and the value of payments made to creditors, and specifying the outstanding liabilities of the bankrupt estate. The court will extinguish the proceedings upon the final report being submitted. It is common for a bankruptcy proceeding to take five to 10 years or longer to finalise.

The debtor company may request that it is declared discharged of its debts when all claims are fully paid or more than 50 per cent of the unsecured claims are paid, after full payment of all claims that are senior to them (including tax claims). The debtor may also apply for discharge after five years following the termination of the proceeding if there is no conviction of a bankruptcy crime, or 10 years in case of conviction. It is worth noting that the 2018 Bill proposes to reduce this time lapse to two years (when there is no criminal conviction).

After the bankruptcy proceeding is terminated and the debtor company is discharged of the debts, it may continue to operate or may be liquidated. In practice, given the lapse of time between the commencement of the bankruptcy proceeding and the discharge of the debtor company, most bankrupt companies are abandoned or irregularly liquidated.

Despite the rigidity of the deadlines establishes by Law 11,101 for the discharge, there are some recent judicial precedents that tend to attenuate such rule, hence decreeing the discharge of the obligations of the debtor company and its shareholders and directors prior to five years of the termination of the liquidation proceeding.

The perspectives for reform

After more than 12 years since its enactment, and although it represented a major improvement over past legislation, Law 11,10 has room for enhancement. And, following the economic crisis triggered by *Operation Car Wash*, which unveiled the world's largest corruption scheme involving governmental entities and some of the largest companies in the country, a reform of the corporate insolvency system is expected.

Currently, the amendments proposed to Law 11,101 are consolidated in the form of the 2018 Bill, which is still under discussion and has to be approved by the Brazilian Congress. Some of the changes proposed by the last official version of the 2018 Bill are favourable and include, among others, features such as:

- clearer rules for the sale of assets free and clear;
- stimulation of debtor-in-possession financing;
- treatment of groups of companies;
- faster and more efficient liquidation proceedings; and
- the incorporation of the UNCITRAL Model Law on Cross-Border Insolvency.

At the same time, however, while many of the changes proposed by the 2018 Bill are positive, a significant number of other amendments are highly controversial, especially in regard to the treatment of the treasury and of tax claims in the insolvency proceedings. The power given to the treasury, which, under the terms of the last official version of the 2018 Bill, can even file for the bankruptcy liquidation of a restructured debtor if the tax claims are not dealt with during the reorganisation, may end up nullifying the positive effects of all the other changes, hence eliminating any real chances of turnaround.

Since its proposal, the 2018 Bill has been subject to many discussions, and the legislative process for its approval has lost some traction within the Brazilian Congress, especially due to the 2018 presidential elections. In the second half of 2019, however, the discussions have regained momentum, and an updated version of the 2018 Bill is currently under discussion. It is hard to know exactly which of the original proposals of the 2018 Bill will remain, but it is estimated that the Bill will be approved by the Brazilian Congress within 2019.

It is essential, however, that the amendments proposed to the corporate insolvency law by the original version of the 2018 Bill be subject to more scrutiny by the Brazilian Congress and by all professionals of insolvency law.

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Canada’s Flexible Restructuring Framework

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In summary

This chapter highlights the flexible nature of Canada’s restructuring regime, where creative solutions to novel and complex issues are welcomed by the judiciary.

Discussion points

- Overview of the two main restructuring statutes (CCAA and BIA)
- The skeletal nature of Canada’s main restructuring statute, and broad judicial discretion
- Examples of novel solutions achieved in various proceedings resulting in successful restructurings

Referenced in this article

- Companies’ Creditors Arrangement Act, R.S.C. 1985, c. C-36
- Bankruptcy and Insolvency Act (Canada), R.S.C. 1985, c. B-3
- Canada Transportation Act, S.C. 1996, c. 10
- Canada Business Corporations Act, R.S.C. 1985, c. C-44
- Winding Up and Restructuring Act, R.S.C. 1985, c. W-11

Introduction

If 'necessity is the mother of invention',[1] then insolvency is a perfect incubator within which creative solutions can emerge. Fortunately for companies that conduct business in Canada, the restructuring options that exist are broad, flexible and respond to even the most unusual of circumstances. Canada's main restructuring statute is relatively bare-bones in nature and is not encumbered by extensive restrictions on what steps may be taken, rigid time frames as to when they must be taken or by limited circumstances in which particular relief may be available.[2] The statutory framework is also supported by a well-developed body of jurisprudence that reflects the willingness of Canadian judges to be responsive to the 'real-time' nature of insolvency proceedings and to grant appropriate relief that fits the unique facts of a particular case. As such, Canada provides a model of efficiency, flexibility and creativity for restructuring solutions.

The two main federal statutes under which debtor companies can seek to restructure in Canada are the Bankruptcy and Insolvency Act (Canada) (BIA)[3] and the Companies' Creditors Arrangement Act (CCAA).[4] Generally, the BIA is utilised by a debtor company:

- when bankruptcy, as opposed to a restructuring, is appropriate; or
- to present a 'proposal' to creditors that is less complicated or will require less judicial oversight than a full restructuring under the CCAA.

For more complex restructurings involving companies with collective bargaining agreements, defined benefit pension plans or cross-border aspects, a proceeding under the CCAA will generally be the chosen path.

Until it was amended in 2009, the CCAA had only 22 sections in total.[5] Notwithstanding its brevity, this statute has provided the basis for the largest and most complex restructurings in Canada – including those involving Air Canada, Stelco, AbitibiBowater, Olympia & York, Nortel Networks and US Steel Canada. One of the most important, and unique, aspects of the CCAA is the following provision:

1 *Republic*, by Plato.

2 When compared, for example, with the extensive provisions of Chapter 11 of Title 11 of the United States Code [US Bankruptcy Code].

3 Bankruptcy and Insolvency Act, RSC 1985, c B-3.

4 RSC 1985, c C-36 [CCAA] Proceedings can also be commenced under the federal Winding Up and Restructuring Act, RSC 1985, c W-11. However, it is generally used in very limited circumstances, when dealing with particular entities such as banks, trust companies and insurance companies.

5 Even after the extensive 2009 amendments the CCAA remains brief, with only 63 sections in total.

General power of court

11. Despite anything in the Bankruptcy and Insolvency Act or the Winding-up and Restructuring Act, if an application is made under this Act in respect of a debtor company, the court, on the application of any person interested in the matter, may, subject to the restrictions set out in this Act, on notice to any other person or without notice as it may see fit, make any order that it considers appropriate in the circumstances.

Since broad judicial discretion is conferred under the CCAA, it is perhaps not surprising that decisions issued by Canadian judges in restructuring proceedings reflect practical, flexible and creative solutions to some of the most difficult issues that arise. That has proven to be the case even where the CCAA appears to be otherwise unavailable to a particular debtor company, where other more traditional avenues for resolution have proven futile or where the facts cry out for a solution and none is readily apparent.

Castor Holdings

One such example can be found in the case involving Castor Holdings Ltd.[6] A national accounting firm in Canada had been embroiled in auditor's negligence litigation spanning 22 years, described by one of the presiding judges as 'the longest-running judicial saga' in Canada. It involved more than 40 plaintiffs (including foreign and domestic financial institutions, insurers and other stakeholders), several associated or successor firms and approximately 400 accounting and other individual professionals across the country.

Restructuring counsel and advisers were retained by the defendant partners of the national accounting firm following two decades of entrenched litigation among the parties.[7] A creative solution was developed to address and resolve all claims through a CCAA proceeding. The proposal involved numerous procedural and substantive hurdles. For example, the threshold requirement for a debtor commencing a CCAA proceeding and obtaining the benefit of a stay of proceedings did not extend to professional firms such as the accounting firm in question.[8] As a result, a unique 'synthetic bankruptcy' mechanism was developed to satisfy stakeholder and plaintiff concerns over the problematic questions of adequate disclosure of assets to satisfy any judgment, and appropriate funding issues on the part of the former partners of the professional firm. After intense negotiations, a 'coalition of the willing' creditors was successfully established to support a structured settlement among a small, but influential group of plaintiffs. Through combined litigation and negotiation tactics, the defendants garnered enough support to pass a plan of arrangement to resolve all claims. Creativity within the CCAA framework, together with the flexibility shown by the Canadian judge, facilitated an efficient resolution to one of the most intractable cases in Canadian litigation history.

6 *4519922 Canada Inc Re*, 2015 ONSC 124 (Ont SCJ [Commercial List]).

7 The author's firm was retained by the partners of the national accounting firm, and commenced the CCAA filing as a means to finally resolve these claims.

8 The court was satisfied that, as one company existed within the affected group, the applicants could qualify as a 'debtor company' within the meaning of the CCAA.

Montréal, Maine & Atlantique Canada

Another case in which the flexibility of Canada's restructuring framework was tested involved a catastrophic loss of life arising from a tragic railway accident, which resulted in significant financial losses to the affected company. In July 2013, a freight train derailed in the village of Lac-Mégantic, in the province of Quebec. In total, 47 people were killed, and the downtown area was effectively destroyed. In the wake of the disaster, numerous claims were filed against the railway company, Montréal, Maine & Atlantique Canada Co (MMA). MMA filed for court protection under the CCAA in August 2013 to obtain a stay of proceedings and provide a comprehensive and binding forum for resolving claims filed against it. A threshold issue to be determined was whether MMA was a 'company' within the meaning of the CCAA, such that it could qualify as a 'debtor company' entitled to seek protection.[9] Section 2 of the CCAA contains a definition of 'company', which specifically states that the term 'does not include . . . railway or telegraph companies'. Similarly, the BIA defines 'corporation' to not include railway companies.[10]

Nonetheless, the court granted the initial order that commenced the CCAA proceeding, allowing the company to develop a plan of arrangement that had the effect of compromising all claims against it. The court found that the very limited insolvency provisions in the Canada Transportation Act[11] left a 'legal vacuum'.[12] As a result, it chose to exercise its inherent jurisdiction under section 11 (reproduced above) to grant an initial order, which provided for a stay of proceedings. The court justified this by focusing on the interests of MMA's creditors, saying that to 'deny MMA the right to avail itself of the [CCAA] would be grossly unfair with respect to the rights of ordinary creditors – including the victims in Lac-Mégantic – and absolutely unacceptable in a society governed by the rule of law'.[13] The court also noted the risk that applying different statutes to different creditors could create inconsistencies and injustices.[14] In other words, substance will prevail over form when the facts demand a practical, timely and equitable solution.

SquareTwo Financial

A further example of the Canadian courts' flexibility in granting relief that responds to unique facts or situations involved a cross-border proceeding before the Canadian and US courts.[15] SquareTwo Financial Corporation involved a group of companies incorporated and doing business in both Canada and the US. Chapter 11 proceedings were commenced under the US

9 *Montréal, Maine & Atlantique Canada Co*, Re, 2013 QCCS 4039 [*Re MMA*].
10 RSC 1985 c B-3, s 2.
11 SC 1996, c 10, which governs insolvent railway companies at sections 106 to 110.
12 *Re MMA*, supra note 10 at para 18.
13 *Ibid* at para 24.
14 *Ibid* at para 25.
15 The author was Canadian counsel for SquareTwo in obtaining the Order referenced above.

Bankruptcy Code for all companies, on the basis that the US was the centre of main interest for the group. Proceedings were then brought in Canada pursuant to the CCAA for recognition of the Chapter 11 proceedings including orders granted by the US court.

This restructuring involved a pre-packaged joint plan of arrangement and was therefore subject to a two-week solicitation period prior to the Chapter 11 petitions being filed in the US. If news of the impending bankruptcy filing had become public prior to the intended date for filing the petitions, the filing date in the US could have been moved up in order to obtain the automatic stay of proceedings under the US Bankruptcy Code. However, that would have created a potential problem on the Canadian side of the cross-border proceeding. The CCAA does not provide for an automatic stay of proceedings upon filing, but rather, a stay is only available pursuant to a court order. The Canadian proceedings were for recognition of the foreign main proceedings brought in the US, and accordingly, recognition could not be sought in Canada until the first-day orders had been issued by a US court. A potential gap could therefore arise where a stakeholder could terminate rights or take certain steps in Canada, before an order recognising the (as yet uncommenced) US foreign main proceedings could be obtained from the Canadian court.

Owing to the nature of SquareTwo's business, it depended upon licences issued by a regulatory authority in each of the provinces and territories in Canada, supported by financial bonds posted in each province. Any suspension or termination of the licences or the bonds that supported the licences, even on a temporary basis, could seriously harm the business and jeopardise the ability to complete the pre-packaged transaction. Provided the businesses were permitted to operate in the ordinary course to facilitate the intended transaction upon filing, creditors in Canada would be unaffected by the pre-packaged joint plan of arrangement and would continue to be paid in the ordinary course.

Faced with different statutory requirements in Canada and the US, and the need to preserve stability to permit a future (intended) insolvency proceeding to be commenced, the Canadian court was satisfied that the provisions of the CCAA permitted extraordinary relief to be granted, based on the particular facts of the case. As a result, the court granted an immediate and unprecedented pre-filing stay of proceedings – prior to the commencement of any insolvency proceedings in Canada or the filing of the Chapter 11 petitions in the US. If any stakeholder had taken steps in the two weeks prior to the commencement of the insolvency proceeding that affected the ability of SquareTwo to carry on its business, the signed and issued order of the Canadian court could be provided to them.[16] The effect of the order was to require compliance with an interim stay of proceedings, and the preservation/reinstatement of rights, from the day on which it was issued (which coincided with the commencement of the solicitation period for the pre-packaged plan of arrangement).

The order was obtained without notice to any party, as to give notice would defeat the very purpose of it, with the original signed order sealed from the public record at the court office until the subsequent commencement of the Chapter 11 proceedings and CCAA

16 As no creditors took steps to enforce their rights during the two-week pre-filing period, the order did not have to be enforced. It therefore served as a form of insurance policy that was never utilised.

recognition proceedings. Counsel for SquareTwo had the only other signed copy of the order. The Canadian court responded favourably to a creative use of various provisions of the CCAA coupled with applicable procedural rules of the court, by showing flexibility and a willingness to facilitate solutions that met the unique requirements of the case.

Asset-backed commercial paper

The largest corporate restructuring under the CCAA also had its share of creative and responsive judicial thinking. The case arose in 2007 out of the freezing of the Canadian asset-backed commercial paper (ABCP) market, caused by worries over exposure of the financial instrument to US sub-prime mortgages. ABCP issuers were not raising enough money from the long-term assets that typically funded the repaying of maturing short-term ABCP, which was leading to ABCPs falling into default. A default of the ABCP market also triggered a default of the credit default swaps (CDS) that underlay the ABCP. A default of the CDS would have left the ABCP holders with little possibility of recovery.

There were several obstacles to successful CCAA proceedings. First, there were a large number of ABCP issuers, most of whom were not related to one another. Second, and relatedly, the wide-ranging group of debtors had a correspondingly wide-ranging group of creditors. As a result, it was difficult to conceive of what the different classes of creditors could be. Third, ABCP was issued predominantly by trust entities. The CCAA definition of 'debtor companies' does not include trusts.

The court was able to overcome these difficulties with a practical and flexible approach. With the consent of the debtors, the court consolidated the proceedings into a single action, rather than running 20 separate proceedings that were each dependent on one another.

The court approved this on the basis that the restructuring plan was very much focused on correcting the ABCP market, rather than being specifically targeted at any individual issuer.

The issuers also requested that creditors vote as a single class. To protect the creditors, the issuers proposed looking at the votes for each series of ABCP notes, and reconsidering the issue of creditor classification if the noteholders of a series did not approve the plan. As the plan was eventually approved by a significant majority of noteholders, and a majority in each series, the potentially fraught and time-consuming process of creditor classification was not necessary.

Lastly, as in the *MMA* case, the issuing trust vehicles were able to bring themselves within the definition of a debtor company, and therefore benefit from CCAA protection. This was done by placing the issuer trust entities into corporations prior to the commencement of CCAA proceedings.

Stelco Inc

Innovative use of the CCAA is not a new phenomenon. In 2004, Stelco Inc was facing financial difficulties, and obtained an initial order granting it protection under the CCAA. Several unions challenged the initial order, arguing that Stelco could not be granted CCAA protection as it was not insolvent, and therefore could not be a 'debtor company' as defined in section 2 of the CCAA.[17]

At the time of the hearing, common practice was to use the definition of insolvency provided for by section 2 of the BIA as the test to be applied.[18] Stelco claimed that it met two of the three tests under the BIA, and the court agreed. However, the court emphasised a second approach. It noted that the CCAA definition of a debtor company had one definition – where a company 'is bankrupt or insolvent' – that did not reference the BIA. The court therefore felt able to analyse whether or not Stelco was insolvent purely in the context of the CCAA.

In conducting this contextual analysis, the court considered the purposes of the CCAA, noting that as a remedial statute, it aimed to allow a debtor company to benefit from its protections before it reached the point where it could no longer be salvaged. The court observed that there was limited value to a restructuring if the company was past the point of being saved, and it was preferable to allow companies to commence a restructuring before it reached that point.

The court therefore indicated that it was willing to allow a company to benefit from CCAA protection where it was 'reasonably expected to run out of liquidity within reasonable proximity of time as compared with the time reasonably required to implement a restructuring'.[19] This would give the company a cushion where it could obtain DIP funding, pursue more thoroughly all possible restructuring opportunities and maximise its chance of a resolution that was viable in the long run.

The unions sought leave to appeal both to the Ontario Court of Appeal, and the Supreme Court of Canada, but both applications were successfully resisted by Stelco. The insolvency test from *Stelco* is now considered part of Canadian insolvency law.[20]

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17 *Stelco Inc, Re*, 2004 Carswell Ont 1211 [*Stelco*].

18 That section provides as follows:

> *'insolvent person' means a person who is not bankrupt and who resides, carries on business or has property in Canada, whose liabilities to creditors provable as claims under this Act amount to one thousand dollars, and:*
>
> *(a) who is for any reason unable to meet his obligations as they generally become due;*
>
> *(b) who has ceased paying his current obligations in the ordinary course of business as they generally become due; or*
>
> *(c) the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due.*

19 *Stelco*, supra note 17 at para 26.

20 For example, the test was used in *Urbancorp Toronto Management Inc, Re*, 2016 ONSC 3288, and *Target Canada Co, Re*, 2015 ONSC 303.

Unlike Chapter 11 proceedings in the US, the CCAA continues to require debtor companies to demonstrate that they are insolvent. However, the flexible approach of the Canadian courts has ensured that the statutory requirement of insolvency has not created unnecessary barriers to commencing a restructuring as early as possible.

Monitor's role and standing to litigate claims

Canada's insolvency regime has a unique feature in the role of a court-appointed monitor in proceedings commenced under the CCAA. While originally selected by the debtor company prior to filing, once appointed pursuant to the initial order made on the date of filing, the monitor is an officer of the court with fiduciary duties to all creditors of the debtor company, and acts as the 'eyes and ears of the court' in the course of the restructuring. It files regular reports with the court, reporting on everything from the cash flow forecast prepared by the debtor company, the terms of DIP financing negotiated by the debtors, the reasonableness of any settlements reached, the status of claims and all other significant aspects of a restructuring. The monitor is an accounting firm that includes licensed trustees in bankruptcy who, in other situations, may be retained as adviser to debtor companies, lenders or other stakeholders.

Courts supervising CCAA proceedings have also used creative orders to give the CCAA monitor powers to litigate on behalf of different groups during the process. The courts have been flexible in their interpretation of standing requirements, to permit claims to be made as efficiently as possible, while avoiding delay.

For example, in *Ernst & Young Inc v Essar Global Fund Ltd*,[21] the Ontario Court of Appeal upheld the decision of Newbould J authorising the monitor to bring an oppression action on behalf of a group of creditors of Algoma.

The monitor sought to challenge a related party transaction, and argued that it (among other things) gave unwarranted value to a related party, and was therefore oppressive to the non-related creditors of Algoma. Potential oppression claimants are typically defined as including 'any other person who, in the discretion of a court, is a proper person to make an application under this Part'.[22]

The court held that, generally speaking, the monitor is to be neutral. However, in 'exceptional circumstances' it may be appropriate for the monitor to serve as a complainant in an oppression action.[23] This was clearly an 'exceptional' case.

The court agreed with the monitor that there was a significant benefit to collective action, where a broad range of creditors could consolidate their attempts to increase their recovery of the large amounts outstanding. While noting that actions where the monitor adopts a non-neutral role were an exception, the benefits of collective action made this an appropriate situation to permit the monitor to bring the claim.

21 *Ernst & Young v Essar Global Fund Limited*, 2017 ONCA 1014 [*Essar Global*].

22 See, for example, section 238 of the Canada Business Corporations Act, RSC 1985, c C-44.

23 *Essar Global*, supra note 21 at para 120.

The broad range of possible powers a court can give to a monitor is an important innovation in CCAA proceedings. It allows significant legal disputes to be settled expeditiously and avoids duplicitous proceedings.

Conclusion

Given the above examples, the reader should not be left with the impression that creativity and flexibility in the Canadian restructuring framework have resulted in the core principle of commercial certainty being compromised or undermined. On the contrary, capital markets in Canada are robust and continue to attract sophisticated participants who thrive in an environment where creative solutions are encouraged and rewarded. This has the benefit of causing stakeholders and their advisers to constantly strive to find better solutions for the most difficult business problems.

* *The author would like to acknowledge the assistance of James Hardy, student-at-law (now an associate) at Thornton Grout Finnigan LLP, in the preparation of this chapter.*

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Cayman Islands

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In summary

This chapter provides an update and recap of material developments in the Cayman Islands in restructuring and insolvency over the past two years.

Discussion points

- New guidance from the Cayman courts on cross-border cooperation between jurisdictions
- Further developments in the jurisprudence on hedge fund redemptions in the context of insolvency
- Some welcome clarity in areas such as third-party funding of liquidation expenses
- Guidance as to when dispositions of assets during winding up will be validated by the courts
- When a winding-up petition will be considered 'cynical and abusive'

Referenced in this article

- JIN Guidelines and Modalities
- Grand Court Practice Directions 1 of 2018 and 2 of 2019
- American Law Institute/International Insolvency Institute Guidelines
- *Case law: Pearson v Primeo; Culross Global SPC Limited v Strategic Turnaround Master Partnership Limited; DD Growth Premium 2X Fund (In Official Liquidation) v RMF Market Neutral Strategies; Skandinaviska Enskilda Banken AB (SEB) v Conway & Shakespeare (as joint official liquidators of Weavering Macro Fixed Income Fund Ltd); Aurora Funds Management Limited et al v Torchlight GP Limited; Ctrip Investment Holding Limited v eHi Car Services Limited; Tianrui (International) Holding Company Limited v China Shanshui Cement Group Limited*

Introduction

The Cayman Islands continues to be at the forefront of developments in restructuring and insolvency law in the offshore world and among common law jurisdictions. As the number one jurisdiction globally for hedge funds, as well as a leading domicile for corporate structures of all types, it is perhaps unsurprising that the Cayman Islands' courts have dealt with such a variety of issues.

Previous country chapters of the *Americas Restructuring Review* have provided a primer for practitioners on the Cayman Islands as a restructuring and insolvency jurisdiction. Here we aim to give readers an update and a recap of material developments in the Cayman Islands since the last country chapter published two years ago.

A brief introduction to the Cayman Islands legal system

The Cayman Islands is a British Overseas Territory with a common law legal system. The doctrine of judicial precedent applies, and where there is no applicable Cayman Islands case law the Cayman courts will usually look to English authorities or decisions of other common law jurisdictions which, while non-binding, will as a general rule be followed to the extent that they are not inconsistent with either Cayman statutory provisions or authorities.

Corporate insolvency in the Cayman Islands is governed by Part V of the Companies Law (2018 Revision) (the Law) and the Companies Winding-up Rules 2018 (the CWR). Those provisions apply both to the winding up of companies – including certain foreign companies – as defined by the Law and (pursuant to Section 36 of the Exempted Limited Partnership Law (2018 Revision)) to the winding up of Cayman Islands exempted limited partnerships.

Hearings at first instance are held at the Grand Court in George Town, Grand Cayman (which has a dedicated Financial Services Decision). Appeals are made to the Cayman Islands Court of Appeal, which is largely made up of former judges of the English High Court and sits at regular intervals through the year in George Town. The Cayman Islands' ultimate court of appeal is the Judicial Committee of the Privy Council (JCPC) in London. The JCPC is made up of current members of the UK's Supreme Court.

Adoption of JIN Guidelines

The Judicial Insolvency Network (JIN) is a network of insolvency judges from across the world with the aim of providing judicial thought leadership, the development of best practices, and communication and cooperation between jurisdictions. The JIN held its inaugural conference in Singapore on 10 and 11 October 2016, which concluded with the issuance of a set of guidelines entitled Guidelines for Communication and Cooperation between Courts in Cross-Border Insolvency Matters (the JIN Guidelines). The first JIN members (which included representatives of the Cayman Islands judiciary) contributed to the drafting of the JIN Guidelines.

The JIN Guidelines address key aspects of communication and cooperation among courts, insolvency representatives and other parties involved in cross-border insolvency proceedings, including the conduct of joint hearings. The JIN Guidelines are adopted in practice through either incorporation in a protocol between officeholders in different jurisdictions, which is subsequently approved by the respective courts; or alternatively imposed from above on the officeholders by the courts in the relevant jurisdictions where the cross-border insolvency is taking place. The overarching aim of the JIN Guidelines is the preservation of enterprise value and the reduction of legal costs. In practice, these aims should be achieved by protocols that allow for the avoidance of duplication of work and conflict, the exchange of information between officeholders, and procedures for coordinating sanction applications as between parallel insolvency proceedings.

Following JIN conferences in 2018 and 2019, further guidelines were issued that focus on the modalities of court-to-court communication in insolvency proceedings (the Modalities). Unlike the JIN Guidelines, which focus on court cooperation at the level of principle, the Modalities focus on the mechanics of court-to-court communication. These include how a court may initiate communication with another court, the arrangements as to time, method and language of communication, and the designation of a facilitator for this purpose. According to JIN, the Modalities seek to 'distil the basic administrative issues a court may wish to address in advance in relation to court-to-court communication, bearing in mind the time, language and cultural differences that may underpin much of cross-border communication'.

The Cayman Islands has incorporated both the JIN Guidelines and the Modalities into Cayman practice and procedure through Practice Directions 1 of 2018 and 2 of 2019 (as well as the American Law Institute/International Insolvency Institute Guidelines).[1] Perhaps unsurprisingly given their very recent adoption, we are not aware of any decisions of the Cayman courts that consider the impact of the JIN Guidelines or the Modalities; however, they are clearly a welcome addition to the practice and procedure of the Cayman Islands given the cross-border nature of much of the insolvency and restructuring work in the Islands.

'The path to redemption is not always smooth.' – Lord Mance[2]

A series of cases relating to high-value redemptions from Cayman Islands hedge funds have come before the Cayman Courts in recent years. By way of background, previous decisions dealt with the status of redeeming investors. In *Strategic Turnaround*,[3] the JCPC had to decide whether Culross, a shareholder who had requested a redemption of its shares but had not received payment due to the suspension of redemptions imposed by the fund after the applicable redemption date, was a creditor. The JCPC held that, under the fund's articles, the shareholder became a creditor on the relevant redemption date, which was when property in its shares passed back to the company and the payment obligation arose. That decision was followed in *Pearson v Primeo*,[4] where the liquidators of the Herald Fund attempted to rely on provisions of the Law that they said subordinated redeeming shareholders behind ordinary

1 Pursuant to paragraph 2 of Practice Direction 1/18.

2 *Pearson v Primeo* [2017] UKPC 19.

3 *Culross Global SPC Limited v Strategic Turnaround Master Partnership Limited* [2010] UKPC 33.

4 [2017] UKPC 19.

creditors. The JCPC rejected the liquidators' analysis and held that redeeming shareholders become creditors at the point of redemption and rank with other unsecured creditors for the proceeds of redemption.

Two recent cases before the JCPC have again focused on the redemption mechanism in relation to Cayman Islands hedge funds; however, in each case, the primary question was not the status of the redeemer as of the commencement of the liquidation, but whether the relevant redemptions could be overturned by the liquidators.

Avenues for liquidators to recover unlawful company payments

In *DD Growth Premium 2X Fund (In Official Liquidation)* (DD) *v RMF Market Neutral Strategies Limited* (RMF),[5] the redeeming investor (RMF) applied to the Grand Court for a declaration that it was not liable to repay redemption proceeds paid to it by DD. In 2008, RMF made a number of redemption requests and in early 2009 received US$23 million. At the time of the payments, DD was cash-flow insolvent and paid the redemptions from share premium. In the Grand Court, DD submitted that the payments were contrary to the Companies Law (2007 Revision)[6] as they constituted payments 'out of capital',[7] which were prohibited unless the paying company was solvent at the time of payment. The Grand Court (Smellie, CJ) held that payments out of share premium that were made in order to redeem shares were not payments out of capital, and the Court of Appeal agreed with those findings.

The JCPC disagreed and held that redemption payments out of share premium are in fact payments out of capital. Such payments can only be made if the company is solvent and since redemption creditor claims are to be considered debts and the fund was not in a position to pay all such debts as they fell due, it therefore failed the solvency test. However, despite finding that the payment had been unlawful, the JCPC went on to find that the proceeds of payment were not recoverable on the basis of unjust enrichment. The basis for the payment of the redemption proceeds was that the shares had been redeemed and cancelled, and a valid debt was owed by the appellant. The appellant's payment of part of the proceeds discharged (in part) the lawful debt. Although the company acted illegally in making the payment, upon receipt, it discharged a valid legal entitlement of the redeeming shareholder. A payment could not amount to enrichment if it was made for full consideration, and it could not be unjust to receive or retain it if it were made in satisfaction of a legal right. The fact that the payment was made by the company in breach of the directors' duties might give rise to a constructive trust over the proceeds, but that was a different area of law and subject to separate questions of knowledge that the company would have to prove in the courts below.

5 [2017] UKPC 36.

6 S.37(6)(a).

7 As defined by s.37(5)(b).

Redeemers: shareholders or creditors?

In *Skandinaviska Enskilda Banken AB* (SEB) *v Conway & Shakespeare (as joint official liquidators of Weavering Macro Fixed Income Fund Ltd)* (Weavering),[8] the JCPC upheld the decisions of the Grand Court and Court of Appeal in finding that certain redemption payments received by SEB from Weavering shortly prior to its liquidation constituted voidable preferences.

SEB had subscribed for approximately US$9.5 million of shares in Weavering as custodian and nominee for two clients. In 2008, many of Weavering's investors sought to redeem their shares. As a result, redemptions totalling US$138.4 million became due to redeeming shareholders on 1 December 2008 (the December Redeemers). Redeeming shareholders with a 2 January 2009 redemption day (the January Redeemers) were owed US$54.7 million. Redeeming shareholders with a 2 February 2009 redemption day (the February Redeemers) were owed US$30 million. SEB was paid just over US$1 million by Weavering on 19 December 2008. It received a second payment of 25 per cent of the balance of the redemption amounts owing to it on 2 January 2009 and a third and final payment of the remaining 75 per cent on 11 February 2009. In total, SEB received approximately US$8.2 million in redemption payments (the SEB Redemption Payments).

All but three large December Redeemers had been paid their redemption claims in full by the time the Company went into liquidation on 19 March 2009, with the balance owed to the unsatisfied December Redeemers being about US$50 million. The January Redeemers and the February Redeemers were never paid.

Weavering's liquidators issued proceedings against SEB seeking a declaration that the SEB Redemption Payments were invalid as preferences under section 145(1) of the Companies Law (2013 Revision),[9] and an order that the monies be repaid with interest.

The JCPC concluded that the courts below were correct to determine that payments had been made with a dominant intention to prefer SEB (as one of the class of December Redeemers). The fact that Weavering had fully discharged SEB's redemption claim, whereas the three largest December Redeemers received only 25 per cent of their claims, was, in the view of the court, itself sufficient to demonstrate a dominant intention to prefer SEB over those partially paid December Redeemers. Further, the fact that Weavering had a policy in place designed to allow December Redeemers to be paid before January Redeemers and February Redeemers, all of whom were, to the knowledge of Weavering, unlikely to be paid, was also held to be a sufficient indication of a dominant intention to prefer SEB. The JCPC left open the question of whether the fact of payment in the knowledge of insolvency is sufficient, without more, to found an inference of the requisite dominant intention to prefer.

8 [2019] UKPC 36.

9 Section 145(1) provides that: 'Every conveyance or transfer of property … made … by the company in favour of any creditor at a time when the company is unable to pay its debts … with a view to giving such a creditor a preference over the other creditors shall be invalid if made … within six months immediately preceding the commencement of the liquidation.'

Similarly to its conclusion in *DD*, the JCPC determined that the right to repayment of the proceeds of unlawful redemption payments is not automatic under statute but merely renders the relevant transfer or payment voidable. The court also accepted that the Weavering liquidators were entitled to restitution of a payment avoided under section 145 at common law on the grounds of unjust enrichment – subject to any defences available to SEB.

A number of points arise from these two cases on redeeming shareholders in Cayman Islands hedge funds:

- redemption requests by shareholders can create a situation of insolvency which itself makes certain payments unlawful;
- the status of a redeeming investor in the distribution of assets from a liquidation estate is now settled law in the Cayman Islands. Once a redemption request is submitted and the redemption day passes without a suspension or gating of redemptions, the shareholder becomes a creditor ranking with all unsecured creditors. However if the relevant redemption day has not passed at the time of suspension then the shareholder remains a shareholder and does not have a creditor claim in any subsequent liquidation (see *Pearson v Primeo*); and
- unlawful payments, and even those that are voidable by operation of statute, do not give rise to an automatic repayment obligation and any liquidator pursuing such a claim must base it on remedies such as unjust enrichment or constructive trust.

The concept of a redeemable share is a relatively novel one; however, it is a key device in the Cayman hedge fund industry, and one through which billions of dollars in value are transferred between investors and funds annually. One of the unforeseen consequences of the liquidity crisis of the past decade is that the Cayman Islands now has a body of jurisprudence from its highest court that leaves little room for doubt as to the status of redeeming shareholders and the claims that liquidators do and do not have against them.

Pragmatic approach: post-winding up dispositions of property

The courts have long exercised oversight in relation to any purported disposition of company shares or property when a winding up has commenced. Section 99 of the Companies Law provides that, upon the making of a winding up order:

> *any disposition of the company's property and any transfer of shares or alteration in the status of the company's members made after the commencement of the winding up is, unless the Court otherwise orders, void.*

In the Cayman Islands, significant value often becomes locked within investment funds pending winding up and distribution. The Cayman courts have therefore generally taken a pragmatic view of transfers within a liquidation, and applications under section 99 are generally processed administratively by the presiding judge without the need for a hearing.

In the recent decision of *Aurora Funds Management Limited et al v Torchlight GP Limited* (Torchlight),[10] the Cayman Islands Court of Appeal was required to consider the principles applying to validation orders under s99 of the Companies Law in the case of a solvent company, being the general partner of Torchlight Fund LP. Torchlight had applied for validation of a variety of payments including in relation to loan repayments, professional adviser fees and management fees payable to itself. Those payments were approved by the judge at first instance, whose decision was appealed by Aurora and other limited partners.

While the application of s99 has typically been limited to sanctioning transactions by insolvent companies, and therefore concerns whether a transaction is in the best interests of the unsecured creditors, the Court of Appeal confirmed the criteria applicable for solvent companies, which will be welcome news for restructuring advisers. The Court of Appeal has endorsed the four criteria laid down by Henderson J in *In re Fortuna Development Corporation*[11] (Fortuna), as supplemented by Smellie CJ in his subsequent judgment in *In re Cybervest Fund:*[12]

> *First, the proposed disposition must appear to be within the powers of the directors … Secondly, the evidence must show that the directors believe the disposition is necessary or expedient in the interests of the company … Thirdly, it must appear that in reaching the decision the directors have acted in good faith. The burden of establishing bad faith is on the party opposing the application. Fourthly, the reasons for the disposition must be shown to be ones which an intelligent and honest director could reasonably hold.*

Henderson J added that 'the test the applicant must satisfy is not high. Nevertheless, there must be a body of evidence which, viewed objectively, establishes that the decision is one which a reasonable director, having only the best interests of the company in mind, might endorse'.

The Court of Appeal held that the judge had examined the evidence concerning each disposition in respect of which validation was sought, measured it against the standard established by the authorities, reminded himself that at this interlocutory stage of the winding-up proceedings he was not required to embark on a mini-trial, noted that several of the dispositions had passed the scrutiny of the independent auditors, and concluded that there was a body of evidence which, viewed objectively, established that the decision was one that a reasonable general partner, having the best interests of the partnership in mind, might endorse.

This decision demonstrates the high threshold that exists where a stakeholder seeks to disturb a finding of fact or the exercise of discretion by the judge in winding-up proceedings. It also shows the pragmatic approach that the Cayman courts have long adopted to reasonable commercial dispositions of property within a winding-up.

10 [2018 (1) CILR 290].

11 [2004–05] CILR 533.

12 [2006] CILR 80.

Just and equitable petition abusive

In dismissing a shareholder's just and equitable winding-up petition on grounds that it was an abuse of process, the Grand Court in *Ctrip Investment Holding Limited* (Ctrip) *v eHi Car Services Limited* (eHi)[13] has sent a warning to shareholders seeking to wind-up a company for an ulterior motive.

The case concerned a petition by a minority shareholder in the context of a proposed take-private of eHi. eHi had its headquarters in Shanghai and its main business was car rental in the People's Republic of China (PRC). The petitioner was part of a leading PRC travel conglomerate that held a 21.3 per cent voting stake in the company. At all material times, it had a representative on the company's board of directors.

Two rival bidders sought to purchase eHi's shares. One bidder was backed by Ctrip while the other rival group was backed by the company's chairman and had its bid recommended by the board of eHi. Ctrip petitioned to wind eHi up on the basis, inter alia, that the interests of the chairman were preferred over the best interests of the company as the consortium's proposal was not the best offer available.

The Grand Court held on the facts that the petitioner's complaints of misconduct were unsustainable. It seemed clear to Kawaley J that they were factually incapable of proof and unmeritorious. In addition, it was clear that the main purpose of the petition was to advance the rival bid supported by the petitioner, not to advance the class interests of the shareholders that the petitioner was supposed to represent.

While the facts in that case were quite specific, of significance for restructuring practitioners was Justice Kawaley's determination that a petitioner cannot use a just and equitable winding-up petition to further its own commercial interests; it can only seek relief designed to vindicate the rights of shareholders generally, or shareholders of its class. Kawaley J held the main purpose of eHi's petition was to advance a rival merger bid supported by the petitioner, not to advance the class interests of the shareholders on whose behalf the petitioner was meant to be representing.

That finding raises questions since it is a hallmark of many just and equitable winding-up applications that there is a tension between the commercial interests of the minority petitioner and the majority of shareholders. In the recent decision of *Tianrui (International) Holding Company Limited v China Shanshui Cement Group Limited*,[14] the Court of Appeal acknowledged that if a creditor's petition did not invoke a class remedy then the petition may be an abuse of process, but doubted the same principle would apply in respect of a shareholder who must be able to petition against acts of the company promoted by other shareholders. The Court suggested that a shareholder acting only in its self-interest 'may support an argument that the petition is brought for an improper purpose. On the face of it, that is what Kawaley J's remarks amount to.'

13 [2018 (1) CILR 641].

14 [2019] CICA J0405-1.

The Court of Appeal's clarification that Kawaley J's findings do not support a wider principle that a petition which advances the commercial interest of a minority shareholder will automatically be deemed abusive is welcome. The just and equitable petition is often the only available remedy for disgruntled shareholders in Cayman Islands' funds where voting rights are often curtailed and there is no statutory remedy for oppression. In circumstances where the courts have set a high bar in recent years for such petitions to succeed (including rolling back the previously broad interpretation of the failure of substratum jurisdiction), it would be an unwelcome outcome for shareholders if such petitions were susceptible to be struck out simply because they further the petitioner's own commercial interests.

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Campbells specialises in insolvency and restructuring, investment fund litigation and liquidation disputes. The group acts for insolvency professionals, creditors, investors, directors and other professional service providers in connection with all aspects of the restructuring and winding up of companies, investment funds, limited partnerships and structured finance entities. They have specific experience of co-ordinating cross-border appointments, obtaining injunctions, assisting with gathering evidence and obtaining recognition and assistance from overseas courts.

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In summary

This chapter explains the Chilean insolvency regime with a special focus on its cross-border insolvency regulation and application in relevant recent cases involving Chilean courts.

Discussion points

- Chilean insolvency domestic regulation and proceeding
- Chilean insolvency regulation for cross-border cases

Referenced in this article

- Chilean Insolvency Act– (Ley N° 20.720, 'Ley de reorganización y liquidación de empresas y personas')
- SUPERIR – Chilean Bankrupcy Agency (Superintendencia de Insolvencia y Reemprendimiento)
- UCBIL – UNCITRAL Model Law on Cross-Border Insolvency
- Arcano Case
- Avendaño Case
- Astaldi Case

Legislative framework

Chile lacked a modern insolvency law until 2014. That year, the Chilean government enacted Law No. 20.720 on Restructuring and Liquidation of Companies and Individuals (the Chilean Insolvency Act). The Chilean Insolvency Act was enacted with the aim, among others, of:

- improving domestic insolvency proceedings by:
  - giving special consideration – through the restructuring procedure – to entrepreneurs' ability to start new businesses following a failure, in order to avoid discouraging entrepreneurship, considering its key role in the Chilean economic growth;[1] and
  - enhancing recovery rates and reducing the length of the liquidation procedure, in order to provide creditors with a timely and orderly process for the collection of their credits in cases of unviable debtor businesses, in-line with international standards and statistics provided by the OECD as well as by the World Bank's Doing Business Reports;[2] and
- providing an effective regulation for addressing cross-border insolvency cases.[3]

The available public data shows that the Chilean Insolvency Act is on the right track according to international standards and has achieved some of the objectives set by the legislator; except for fostering in reorganisation proceedings where there has been no actual improvement.

A 2018 working paper from the OECD's Economics Department[4] explored cross-country differences in key features of insolvency that have been found to impact the timely initiation and resolution of personal and corporate insolvency proceedings. Insolvency regimes

1 See Chilean Insolvency Act Bill Introductory Message, p. 5. The new law was truly needed. The repealed insolvency law was specifically entered for solving the economic crisis that affected Chile during the first years of 1980's, and thus, it was mainly focus in providing a fast and effective liquidation process for creditors regarding Chilean insolvency corporations, without giving any actual consideration to: the extent to which that law would limit entrepreneurs' ability to start new businesses following a failure; or address situations of corporate insolvency and financial distress involving companies with cross-border creditors.

2 See Chilean Insolvency Act Bill Introductory Message, p. 5.

3 See Chilean Insolvency Act Bill Introductory Message, p. 8.

4 Adalet, Müge & Andrews, Dan (2018): *Design of Insolvency Regimes across Countries*. OECD, Economics Department, Working Paper No. 1504. In relation to the studied indicators, first, personal costs refer to the extent to which insolvency regimes punish failed entrepreneurs. Within this indicator, the paper analysed: the time to discharge (ie, the number of years a bankrupt must wait until they are discharged from pre-bankruptcy indebtedness); and the extent of exemptions of assets of the debtor that are not directly linked to the business. Second, prevention and streamlining concerned the possibility of early resolution of debt distress through the availability of: early warning systems; preventative restructuring frameworks such as pre-insolvency regimes; and special treatment for small and mediums enterprises (SMEs). Third, as regards barriers to restructuring, the authors looked at design features which lowered barriers to restructuring, including: the opportunity and incentives given to creditors for the initiation of restructuring proceedings; the existence and length of a stay on assets stopping premature liquidations; priority given to new financing; approval of restructuring plans by a qualified majority of creditors (ie, not requiring unanimity); and allowing managers to stay in charge of firms in distress. Finally, other features, namely: limiting court involvement only to indispensable procedural steps; distinctions between honest and fraudulent entrepreneurs; and the removal of stringent restrictions on worker and collective dismissals, were also considered.

of OECD members were quantitively analysed based on a questionnaire evaluating 13 design features, grouped into four composite indicators, with results being graded on a 0 (closest to best practice) to 1 (furthest from best practice) scale. A comparison of indicator values for 2010 and 2016 was made.

Among the 13 key features measured in the study, Chile's 2014 Insolvency Act seems to have brought about marked improvements in relation to itself and relative to its OECD peers. As shown in Table 1, Chile improved in five of the 13 design features during the 2010–2016 period, bettering its score in all four composite indicators. Whereas in 2010 Chile lagged far behind the OECD average, it now ranks eight in the group, boasting an average score of 0.25 when considering all 13 key features. Although these improvements occur in the context of overall OECD progress in insolvency regime design, the authors recognise Chile among the 'countries with the biggest reform in this area'.[5]

Table 1: OECD and Chile scores in specific key features of insolvency regimes (2010–2016)

Composite Indicator	Feature	2010 OECD	2010 Chile	2016 OECD	2016 Chile
Personal costs	Time to discharge	0.64	1	0.59	0
	Exemption of assets	0.46	0.5	0.43	0.5
Prevention and streamlining	Early warning systems	0.68	1	0.61	1
	Pre-insolvency regimes	0.5	1	0.29	0
	Special procedures for SMEs	0.86	1	0.66	0
Barriers to restructuring	Restructuring by creditors	0.44	1	0.37	1
	Length of stay on assets	0.5	0	0.46	0
	Priority of new financing	0.4	1	0.33	0.5
	Cram-down	0.32	0.5	0.26	0.5
	Retention of management	0.11	0	0.11	0
Other features	Degree of court involvement	0.69	0.8	0.69	0.8
	Honest and fraudulent bankrupts	0.32	0	0.24	0
	Rights of employees	0.35	1	0.32	0.5
Average		**0.48**	**0.7**	**0.41**	**0.25**

Prepared by the authors on the basis of OECD data.

Similarly, the World Bank's Doing Business reports show that the Chilean insolvency proceedings have evolved since 2014, both in terms of the duration of the insolvency proceedings and regarding the recovery rate.

5 Adalet, Müge & Andrews, Dan (2018): Design of Insolvency Regimes across Countries. OECD, Economics Department, Working Paper No. 1504. p. 18.

Table 2: Chilean Insolvency Index – World Bank

	Time (Years)[6]	Recovery rate (cents on the dollar)[7]
2014	3.2	29.1
2015	3.2	30.0
2016	3.2	31.0
2017	3.2	33.5
2018	2.0	40.8

Prepared by the authors on the basis of World Bank data.

Furthermore, the Chilean Insolvency Act solved the former regulation's lack of cross-border insolvency rules by adopting the UNCITRAL Model Law on Cross-Border Insolvency. Indeed, Chilean courts are currently applying the principles and regulations advocated by UNCITRAL in cross-border insolvency cases that involve both foreign creditors regarding companies with assets in Chile and cases in which Chilean creditors are pursuing assets located abroad (see 'Cross-border insolvency proceedings' section, below).

The following section briefly describes the insolvency proceedings applicable to enterprises. The final section describes the Chilean cross-border insolvency regulation and provides a description of recent cases in which such regulation has been applied.

Bankruptcy proceedings

The Chilean Insolvency Act provides for different types of proceedings, depending on whether the debtor is an enterprise or an individual. Notably, the Chilean Insolvency Act applies the enterprises' insolvency proceedings to those individuals whose income originates from liberal professions, such as doctors, lawyers and tax consultants (ie, individuals who do not receive a salary as dependent workers).[8] [9]

For individual debtors, the Chilean Insolvency Act provides two types of proceedings:

- a renegotiation procedure, whose aim is to assist debtor and creditors in reaching an agreement for renegotiating the former's debt; and
- a liquidation procedure of the individual debtor's assets.

6 The 'time' item considers the number of years required for creditors to recover their debt. The period measured by Doing Business ranges from non-payment of debt to payment of part or all of the amount due to the bankrupcy. Delays arising from delaying legal tactics used by the parties, such as the filing of appeals or requests for postponement, are taken into account.

7 The recovery rate is based on the time, cost and result of insolvency proceedings in each analysed economy.

8 See Chilean Insolvency Act, Art. 2.13). Accordingly, an 'enterprise' considers both legal entities of private law as well as individuals whose income originates from liberal professions, even if those individuals do not actually run an actual business.

9 President sent a bill to Congress to treat the individuals whose income originates from liberal professions as common individuals, and that creates a concept of 'smaller company'. See Bill No. 12025-03 before the Chilean Senate.

The law deliberately refrained from naming the latter 'liquidation of the individual debtor' to avoid stigmatising those individuals whose businesses became insolvent.

For enterprise debtors, the Chilean Insolvency Act also provides two types of proceedings:

- a reorganisation procedure, the aim of which is to assist debtor and creditors in reaching an agreement regarding a reorganisation and restructuring of the debtor's business operations and its debt, in order to allow the debtor to continue operating its business and pay its debts; and
- a liquidation procedure, the aim of which is to orderly liquidate a debtor's assets to pay its liabilities in a single procedure with all of its creditors.

Although the Chilean Insolvency Act was enacted with a preference for restructuring solutions over liquidation schemes (ie, to shift from the Chilean traditional pro-liquidation focus to the promotion of an efficient reorganisation of debtors),[10] practitioners and judges agree that reorganisation proceedings still represent a minor portion of actual Chilean insolvency cases.[11]

The following sections briefly describe the insolvency proceedings applicable to enterprise debtors.

The reorganisation procedure for enterprises

Key benefits of filing a restructuring petition include, among others:

- the imposition of an automatic stay to provide the debtor with protection from creditors and time to negotiate – and potentially reach an agreement – with its creditors for restructuring its financial affairs as well as for orderly paying its debts; and
- the possibility of tackling a forced liquidation proceeding and replacing it with a restructuring one.

The reorganisation procedure considers the following main stages, which, according to the Chilean Insolvency Act, must last up to four months:

10 See Chilean Insolvency Act Bill Introductory Message, p. 7.

11 See https://www.senado.cl/senadores-estudian-los-cambios-que-requiere-la-ley-de-quiebras-a-4-anos/senado/2018-10-19/125357.html

Restructuring petition

A reorganisation procedure commences with the filing of a restructuring petition with the competent court (the general jurisdiction court the debtor is domiciled). No specific requirements apply for filing a restructuring petition. In fact, the distressed company may file a restructuring petition even during a forced liquidation proceeding.[12]

Nomination of the insolvency overseer

After filing for a reorganisation procedure before the court, the distressed company must request that the Chilean Insolvency Agency (SUPERIR) nominate an insolvency overseer. Since the debtor company will generally continue to operate its business, the insolvency overseer has a two-sided role: it must assist the debtor and its creditors to reach a reorganisation agreement; while, at the same time, it must oversee and safeguard the creditors' collection ability, requesting the applicable interim conservative measures to the court when necessary. The insolvency overseer is elected by the debtor's major creditors.[13] Finally, the SUPERIR informs the court of the elected insolvency overseer by sending a letter to the court.

Reorganization Procedure resolution and triggering the Financial Protection Period

The debtor must file with the court a report describing its assets and debts. The debtor has therein to identify its pledged or mortgaged assets that are 'essential to run its business', and thus to comply with the payment plan agreed in the proposed reorganisation agreement. The assets declared by the court as 'essential to run' the debtor's business may not be foreclosed during the term of the reorganisation agreement.

If the financial report is deemed complete by the court, it issues a resolution opening the Reorganization Procedure.

From the date in which the reorganisation procedure decision was issued and for the following 30 days, the debtor benefits from a period of financial protection (Financial Protection Period) that can be extended for up to 60 days. The Financial Protection Period aims to grant the parties a reasonable and protected time frame for reaching a reorganisation agreement. The Financial Protection Period involves the following effects or advantages:

- it is forbidden from declaring the insolvent enterprise's liquidation or filing liquidation, foreclosure or restitution proceedings against it – any of the prior proceedings will be stayed, as well as the applicable statute of limitations;
- the term of all contracts entered into by the insolvent enterprise shall not be unilaterally altered – therefore its creditors are not entitled to terminate any of these agreements, nor accelerate or enforce any guarantees based on the commencement of insolvency proceedings;

12 See Chilean Insolvency Act, Art. 120.2 c).

13 See Chilean Insolvency Act, Art. 37.

- if the insolvent enterprise appears in a public registry as a subcontractor or supplier of a service, it may not be discriminated by the authority with its deletion or forbidden from participating in public tenders, as long as it has complied so far with its related obligations;
- the insolvent enterprise management will be under the insolvency overseer's supervision;
- the insolvent enterprise is unable to create security interests over its assets or to dispose of them, except within its ordinary course of business; and
- where the insolvent enterprise is a legal entity, it will not be able to amend its by-laws, articles of association or the authority of its representatives. Also, the transfer of shares in order to be registered in the entity's register will require the overseer's authorisation.

The last restriction does not apply when the insolvent enterprise is a public corporation that publicly offers its shares.

Reorganisation proposal

In the Reorganization Procedure resolution, the court will order the insolvent enterprise to provide a reorganisation agreement proposal. The law does not specify the proposal's content; instead, it provides that the insolvent enterprise may propose any measure to restructure its liabilities and assets. Moreover, the law entitles the insolvent enterprise to propose different agreements to its secured and non-secured creditors or even propose one or more alternatives to a specific category of creditors.

The Chilean Insolvency Act resolved one of the biggest issues regarding the measures that can be entered under a reorganisation agreement. Under the repealed insolvency law, creditors had to pay a tax of 35 per cent over any remitted or condoned debt to the insolvent debtor; which certainly discouraged several reorganisation agreements. The Chilean Insolvency Act permits creditors to consider some debt remissions as a deductible expense for tax purposes, thus avoiding paying over those deductions.

The only relevant limitation set by the Chilean Insolvency Act is that the reorganisation agreement proposal and its conditions or modalities must be the same for all creditors of the same category. The Chilean Insolvency Act provides two possible categories of creditors: secured creditors and non-secured creditors. However, that does not necessarily mean that those are the only admitted categories that can be used in a reorganisation proposal. Although some commentators have argued in favour of only admitting as valid those two categories of creditors (ie, secured and non-secured creditors),[14] others have recently concluded that debtor and creditors can agree on other alternative categories.[15] In fact, there are precedents in

14 See Puga, Juan Esteban (2014): Derecho concursal. El acuerdo de reorganización (4ª ed.). Santiago. Chile: Edit. Jurídica de Chile, p. 207.

15 See Jequier, Eduardo (2017): La primera clase de créditos en el procedimiento concursal de reorganización judicial en Chile: ¿la gran ausente?. CES Derecho Review, Vol. 8, Núm. 2.

which the debtor has proposed reorganisation agreements considering additional categories of creditors to the ones explicitly described in the Chilean Insolvency Act, which have been approved both by the creditors and the courts.[16]

Possible outcomes

The reorganisation proposal shall be voted by the debtor's creditors in a creditors' meeting.

If the reorganisation proposal is rejected by the creditors, the court will immediately issue a liquidation resolution, unless creditors representing at least two-thirds of the total credits of the debtor agree to allow the debtor to submit a new proposal.

If the reorganisation proposal is approved and becomes final, the debtor and its creditors (whether they voted or not) become bound by it.[17] The agreement's approval requires the debtor's consent and approval by each category of creditors, which in turn requires the favourable vote of creditors representing at least two-thirds of the total debt with right to vote attending the meeting corresponding to the relevant category of creditors (only creditors whose claims appear in the list of recognised credits shall be entitled to vote). Notably, the approval of the proposal regarding a certain category of creditors would be subject to the condition precedent that the proposal shall also be approved by the other categories of creditors contemplated in said proposal – the law intends to prevent a class of creditors with particularly large credits from imposing unfavourable conditions on classes of creditors that represent smaller credits.[18]

In the five days following the publication of the approved proposal in the Insolvency Gazette (*Boletín de Quiebras*), creditors may challenge the proposal on the grounds set in the Chilean Insolvency Act. If the proposal is not challenged (or if the challenge made by creditors is rejected), the court issues a resolution declaring the proposal as approved. This resolution may be appealed without suspending the liquidation procedure.

Enforcement

The Chilean Insolvency Act requires an overseer to be appointed for at least one year from the approval of the reorganisation agreement, in order to supervise compliance with it.

Any of the creditors affected by the debtor's lack of performance or conduct that has aggravated the poor condition of its business is entitled to file a lawsuit against it. However, the Chilean Insolvency Act allows the debtor to comply in a specific time frame in order to avoid the consequences of lack of compliance.

If the court declares that there was lack of compliance or that the agreement was void, once the judgement is final and conclusive it will issue a liquidation resolution.

16 See, for example, Docket Case No. C-3736-2019, 11° Juzgado Civil de Santiago.

17 However, the secured creditors will be able to execute their collateral outside the insolvency process, if their collateral are assets that have not been declared as 'essential for the debtor's business'.

18 See Contador, Nelson & Palacios, Cristian (2015): *Procedimientos Concursales*. Santiago. Chile: Edit. Thompson Reuters, p. 111.

The Simplified (or out-of-court) Reorganization Proposal

The Chilean Insolvency Act also provides a simplified reorganisation procedure that considers a 'pre-packaged insolvency proposal'. Under the simplified reorganisation procedure, any insolvent enterprise can enter into a simplified reorganisation agreement with its creditors and submit it to the competent court for approval.

The Chilean Insolvency Act is stricter with the creditors' support needed for its approval because it requires the support of two or more creditors who represent at least three-quarters of each category.

The court oversees the reorganisation proposal it complies with the applicable legal requirements and, if it does, the court issues a Simplified Reorganization Resolution rendering the agreement binding for the debtor and its creditors.[19]

Here, the Chilean Insolvency Act provides that an overseer's report is required, mainly regarding the probability of compliance with the agreement and how much the insolvent enterprise's creditors would receive if it was liquidated instead.

Furthermore, the court may require that creditors appear in court to accept it or reject it. Following the acceptance, if requested, and absent an objection, the court shall approve the simplified reorganisation proposal.

According to the public records available at the SUPERIR website, only two simplified reorganisation proposals have been filed up to date.[20]

The liquidation procedure

The liquidation procedure's purpose is to orderly liquidate an insolvent enterprise's assets to pay its creditors. The Chilean Insolvency Act provides voluntary and compulsory liquidation processes.

The voluntary liquidation procedure considers the following main stages:

The compulsory liquidation procedure considers the following main stages:

The entire duration of the liquidation process varies depending on multiple factors, though.

19 See Chilean Insolvency Act, Title 3.

20 See https://www.boletinconcursal.cl/boletin/procedimientos.

Liquidation procedure petition and the debtor defence

As mentioned above, the Chilean Insolvency Act provides a voluntary and a compulsory liquidation procedure. While the debtor is the only one able to file a voluntary liquidation procedure petition, the compulsory procedure petition could be filed by any creditor before the court competent in the territory of the debtor's domicile. Notably, the compulsory procedure could even be declared by the court ex-oficio under certain circumstances.

Any creditor can file a compulsory procedure petition, provided that:[21]

- the debtor has a 'ready-to-be-enforced' overdue debt with such creditor;
- the debtor has two or more 'ready-to-be-enforced' overdue debts from different obligations, at least two foreclosure proceedings have been initiated against the debtor, and the debtor has not deposited with the court enough assets to pay both overdue debts as well as the applicable collection costs; or
- the debtor or its representatives have fled and the debtor's office has been shutdown without having appointed a representative with enough powers to comply with the debtor's obligations and be served.

The liquidation petition filed by a creditor must be accompanied by a security deposit of UF 100 (US$3,800).[22]

Although the debtor can challenge the liquidation petition made by a creditor, its response can only be based on the limited defences set by the law (eg, that the alleged debts have been already paid or have been extinguished by other means).

The court issues a liquidation resolution (the Liquidation Resolution) once the liquidation petition fulfils the requirement set by the Chilean Insolvency Act (and the debtor response is rejected, if applicable). This resolution may be appealed without suspending the liquidation procedure.

The Liquidation Resolution

The Liquidation Resolution produces, among others, the following effects.

Management forbiddance

The insolvent enterprise becomes immediately inhibited from managing its existing assets. A liquidator will be in charge of managing the debtor's assets, except for the assets acquired by the debtor pursuant to non-gratuitous titles after the issuance of the Liquidation Resolution.

Determination of creditors' rights

The Liquidation Resolution irrevocably determines the rights of all creditors as of the date it was issued – the credits' amounts, guarantees and securities may not be modified thereafter.

21 See Chilean Insolvency Act, Art. 117.

22 See Chilean Insolvency Act, Art. 118.

Maturity and enforceability of all monetary debts

All debts become due and payable, in order to enable the creditors to intervene in the monetary liquidation proceeding and collect the distributed payments up to the current value of their respective credits.

Voluntary set-off prohibition

Any set-off of reciprocal obligations between the insolvent enterprise and the creditors that would not have occurred by the mere operation of the law prior to the Liquidation Resolution becomes outlawed. Exceptionally, it may operate over related liabilities derived from the same agreement or negotiation.[23]

Accumulation of trials

All pending civil cases against the insolvent enterprise before any court shall be joined to the liquidation proceeding, except for those contemplated by law (eg, compulsory arbitral proceedings). After the Liquidation Resolution notice, all civil lawsuits shall be tried in the court knowing the enterprise's liquidation.

Extinction of interim measures and attachments

All interim measures and attachments ordered prior to the Liquidation Resolution will become immediately void.

Suspension of the creditors' right to individually foreclose the insolvent enterprise's assets

Once the Liquidation Resolution is issued, the right of all creditors to individually foreclose the enterprise's assets is suspended. Despite this, the secured creditors will, in general, still be able to continue with its individual foreclose proceeding or to commence a new one. These creditors may also exercise this right in the context of the liquidation proceeding. In all cases, the foreclose proceeding is only limited to the secured asset and receiving the proceeds of collection is subject to the requirement of guaranteeing their contribution to the payment of certain preferred credits in case the other assets are insufficient to cover them.

Verification of credits

During the 30 business days following the notification of the Liquidation Resolution, the creditors must report to the court their credits against the debtor with the court, in order to be considered for the liquidation process. This period is calculated differently depending on

23 Note that this category includes derivative transactions entered into under the same master agreement, provided that the latter is one of the forms recognized by the Central Bank and subject to certain restrictions imposed by the latter to some institutional investors.

whether the creditor resides in Chile or abroad. The creditors that report their credits after said deadline would only be able to collect from what remains after having paid the creditors who verified their credits in a timely manner.

In the 10 business days following the publication of the Liquidation Resolution in the Insolvency Gazette (*Boletín de Quiebras*), the insolvency liquidator, the debtor or any of the creditors that have reported their credits in a timely manner can challenge any of the other reported credits in the liquidation process. Finally, the court issues a resolution determining:

- the credits that will be excluded for the liquidation process;
- those that will be admitted for the collection process; and
- the right to vote that each admitted creditor will have in the creditors' meetings.

Liquidation and payment

Finally, the creditors' meeting defines the ways by which the debtor assets will be sold or liquidated. Once the creditors admitted for collection are paid with the proceeds of the debtor's liquidated assets, the liquidator issues a final account report.

If the creditors or the debtor do not challenge the final account report, or if, having challenged it, the court rejects those objections, the court issues a final resolution ending the insolvency process.

Once the resolution declaring the termination of the liquidation procedure becomes final, the outstanding balances of the debtor's obligations are deemed extinguished for all legal purposes.

Fraudulent tranfers

The Chilean Insolvency Act provides that, subject to certain conditions, all acts, agreements or payments that are entered into or performed within certain time frame prior to the commencement of a reorganisation or liquidation proceeding, and that jeopardise the liquidation estate, may be challenged with the aim of declaring them unenforceable. The relevant lawsuits may be filed by any of the creditors or, under certain circumstances, by the liquidator or the overseer within one year from the reorganisation or liquidation resolution.

Conditions for this challenge action depend on the nature of the acts, agreements or payments that may be subject to an objective (ie, without defences such as good faith and lack of knowledge being available) or subjective (ie, admitting such defences) regime.

Objective regime

The following acts are subject to the objective regime if they were executed within one year before the commencement of the insolvency proceedings:

- all payments made prior to the maturity date of the obligation;
- all payments of obligations made in a different manner from the original terms of the contract;
- all the mortgages, pledges and antichresis created to secure previously existing obligations; and

- acts and agreements for no consideration.[24]

Furthermore, all the amendments to the articles of association of the debtor in liquidation that entailed a decrease of the debtor's equity, executed within the six months prior to commencement of an insolvency procedure, are also subject to this regime.

Subjective regime

Any acts or contracts other than those described above that are entered into, performed or executed within the two years prior to the reorganisation or liquidation proceeding was initiated may be declared unenforceable against the debtor's creditors in case the plaintiff proves the fulfilment of each and all of the following requirements:

- knowledge by the counterparty of the poor condition of the debtor's business; and
- that the act or contract has damaged the creditors or altered their equal standing in the insolvency proceedings.

The Chilean Insolvency Act considers that an act or contract that was not entered into arm's-length conditions causes damages to the creditors.

Cross-border insolvency proceedings

Scope

The Chilean Insolvency Act introduced a new Chapter IV adopting the UNCITRAL Model Law on Cross-Border Insolvency. Chapter IV basically applies when:

- a foreign representative requests assistance to a Chilean competent insolvency representative, courts, liquidator and other persons involved in insolvency proceedings concerning a foreign insolvency proceeding;
- a Chilean competent insolvency representative requests assistance to a foreign competent insolvency representative, concerning a pending Chilean insolvency proceeding; or
- both a foreign insolvency proceeding and a Chilean insolvency proceeding in Chile are being conducted simultaneously with respect to the same debtor.

Chapter IV does not apply to the special insolvency proceedings applicable to banks and to certain financial entities.[25]

24 Note that in this case the term is extended up to two years in case the act or agreement was in favour of a related party.

25 See Chilean Insolvency Act, Art. 300.

Recognition of a foreign proceeding and reliefs

Any qualified representative empowered to act in a foreign insolvency proceeding can directly file petitions with the Chilean competent court through any lawyer admitted to practice in Chile; the involvement of the applicable foreign insolvency court or agency is not required for that purpose.

The petition for the recognition of a foreign proceeding must be filed before the Chilean courts by a lawyer admitted to practice in Chile and be accompanied by the applicable documents established in the law, duly legalised and translated into Spanish if applicable.

From the filing of the petition for recognition until the petition is decided upon, the court may, at the request of the foreign representative, where relief is urgently needed to protect the assets of the debtor or the interests of the creditors, grant relief of a provisional nature.

If the petition for the recognition of a foreign proceeding fulfils the Chilean Insolvency Act's requirements, the court issues a resolution recognising the foreign insolvency proceeding. The recognition resolution – as with the UNCITRAL Model Law on Cross-Border Insolvency – distinguishes between a foreign main proceeding and a foreign non-main proceeding.

Upon recognition of a foreign proceeding that is a foreign main proceeding, by virtue of law:

- commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities is stayed;
- execution against the debtor's assets is stayed; and
- the right to transfer, encumber or otherwise dispose of any assets of the debtor is suspended.

In the case of a foreign non-main proceeding, the court decides whether to grant all or any of the above relief.

Without prejudice to the foregoing, whether main or non-main, where necessary to protect the assets of the debtor or the interests of the creditors, the court may grant additional reliefs pursuant to article 320 of the Chilean Insolvency Act.

Petitions for the recognition of a Chilean proceeding before foreign proceedings and cooperation with foreign courts and foreign representatives

Under the Chilean Insolvency Act, the body entitled to act before foreign courts is the SUPERIR. However, the SUPERIR can delegate its powers to the insolvency administrators who are intervening in the applicable Chilean insolvency proceedings.

The review and processing of the recognition petition will be regulated by the applicable foreign law.

The Chilean Insolvency Act contains specific rules for the cooperation and direct communication with foreign courts and foreign representatives for parallel insolvency proceedings. It states that the cooperation between the courts and representatives may be implemented by any appropriate means, including:

- appointment of a person or body to act at the direction of the court;
- communication of information by any means considered appropriate by the court;
- coordination of the administration and supervision of the debtor's assets and affairs;

- approval or implementation by courts of agreements concerning the coordination of proceedings; and
- coordination of concurrent proceedings regarding the same debtor.

The Chilean Insolvency Act closely follows the UNCITRAL Model Law on Cross-Border Insolvency regarding the rules of payment for concurrent foreign proceedings.[26]

Major events or developments

There have been three relevant cases of cross-border insolvency proceedings under Chapter IV of the Chilean Insolvency Act.

The first one is *Arcano.*[27] Arcano is a corporation active in Chile, the United States, England and Australia that was involved in several Ponzi scheme allegations. Arcano and its founder, Alberto Chang, are under liquidation proceedings in Chile. The current insolvency cases have been conducted with the cooperation and coordination between the Chilean insolvency authorities and the insolvency representatives of the foreign countries where Arcano and Chang have operations and assets. Cooperation with the foreign authorities made it possible to seize and liquidate assets located abroad.[28]

In *Avendaño*, the Chilean courts issued a resolution recognising the foreign liquidation proceeding conducted in the United States' courts against Claudio Pablo Avendaño Lucero.[29] In its recognition resolution, the Chilean court ordered an interim relief suspending the right of Mr Avenaño to dispose of real estate located in Chile and authorised the creditors' representative in Chile to conduct the applicable acts to liquidate such real state.

Finally, in *Astaldi*,[30] Astaldi SpA (an Italian multinational major construction company) applied for a main foreign proceeding recognition before the Chilean court in order to obtain a resolution issuing a Financial Protection Period for its agency in Chile. Astaldi's agency is active in relevant construction contracts in Chile for public facilities.[31] On April 2019, Astaldi's creditors approved the restructuring plan proposed by Astaldi's agency in Chile, by which Astaldi agreed to pay US$58 million within a three-year period.

26 See Chilean Insolvency Act, Art. 330. See also UNCITRAL Model Law on Cross-Border Insolvency, Art. 32.

27 See the Case Docket Number C-10134-2016, 25° Juzgado Civil de Santiago.

28 See https://www.duna.cl/noticias/2016/06/13/caso-arcano-corte-de-apelaciones-congela-bienes-de-alberto-chang-en-el-extranjero.

29 See the Case Docket Number C-2660-2017, 2° Juzgado de Letras de La Serena.

30 See the Case Docket Number C-34530-2018, 19° Juzgado Civil de Santiago.

31 See https://www.bnamericas.com/es/noticias/astaldi-evita-quiebra-en-chile.

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Cristóbal Eyzaguirre specialises in commercial arbitration and litigation, corporate, banking and financing matters, mergers and acquisitions, syndicated loans, capital markets, project financing, debt restructuring, bankruptcy, private equity investments and antitrust.

From 1997 to 2003, he served in various senior positions at Citigroup, including managing director, general counsel and compliance director of Citigroup Latin America (based in Florida), general counsel of the Global Corporate and Investment Bank of Citigroup Latin America (based in Florida) and general counsel of Citigroup Chile (Santiago). Previously, he was with Shearman & Sterling, New York, from 1994 to 1995.

He was elected in a survey conducted by *Revista Capital* among the General Counsels of the largest Chilean listed companies as the best Chilean lawyer in years 2010, 2011 and 2012 (the survey was discontinued that year). He has also been chosen as one of the leading Chilean practitioners in litigation, antitrust, banking and finance, arbitration and mergers and acquisitions by *Chambers and Partners*. He is professor of civil law at the Pontifical Catholic University of Chile Law School. Previously, he was professor of the masters in business law at the Pontifical Catholic University of Chile Law School (teaching bankruptcy and debt restructuring) and at Universidad de Los Andes Law School (teaching shareholders agreements and corporate directors' liability).

He is a board member of the nonprofit organisation Sociedad Protectora de la Infancia.

He joined Claro & Cia in 1988 and has been a partner since 2004.

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Rodrigo Ochagavía has extensive experience in corporate finance, including banking and finance, capital markets, debt restructuring, mergers and acquisitions and energy.

He has represented a broad range of clients, including lenders, borrowers, purchasers, sellers, governments, investors, financial advisers, issuers, credit enhancers and underwriters. In the energy sector, he has represented generators, transmission and distribution companies.

He was one of the two most voted Chilean lawyers in a survey conducted by *Latin Lawyer* in 2003 choosing the 20 best Chilean lawyers under 40 years of age. He has also been chosen as one of the leading Chilean practitioners in banking and finance, projects, energy and mergers and acquisitions by *Chambers and Partners*; in banking and capital markets by *Who's Who Legal*; and in banking and finance and mergers and acquisitions by *IFLR*.

He is a professor of business law at the Pontifical Catholic University of Chile Law School, and for 10 years was a professor of mergers and acquisitions in the masters in business law at Los Andes University.

He is a member of the Chilean Bar Association and the International Bar Association.

He joined Claro & Cia in 1997 and became partner in 2001. He was previously with Simpson Thacher & Bartlett in New York from 1996 to 1997, and Carey & Cia in Chile from 1990 to 1995.

Santiago Bravo S
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Santiago Bravo concentrates his practice in litigation and arbitration, antitrust and bankruptcy and debt restructuring.

He was assistant professor of civil law and antitrust law at the University of Chile Law School, where he was also coordinator of the Economic Law Review.

He joined Claro & Cia in 2010, and between 2016 and 2017 worked as an international lawyer at Cleary Gottlieb Steen & Hamilton, New York

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Dominican Republic

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In summary

This chapter discusses the DR's Insolvency Law, which came into force in February 2017. It promotes and facilitates company reorganisation. Most of its procedures, including nullity claims, will be used during restructuring or negotiation, not liquidation.

A restructuring request can immediately transition from verification to liquidation, without going through reorganisation, disabling any nullity claim. A recent decision held that creditors cannot file nullity claims during liquidation, even in the event of possible voidable transactions.

Further, most insolvency officials are very wary on how courts assess their fees. Owing to lack of knowledge, most courts do not authorise advancement for officers' fees, which end up advancing and bearing all expenses incurred.

Discussion points

- Unfeasibility of nullity claims during liquidation
  - Reserved for conciliator
  - No appeal
- Officers' fees
  - Criteria to grant advance payment of fees
  - Effects of appeals of liquidation decisions

Referenced in this article

- Insolvency Law 141-15 is the principal legislation that governs insolvencies and restructuring procedures in the Dominican Republic.
- Rules of application of Law 141-15 – Executive Decree No. 20-17.
- Liquidation of Pawa Dominicana
- Liquidation of 33 Renova SRL
- Liquidation of Mones Packaging Solutions Mopack
- Reorganisation of Munné, SRL
- Reorganisation of Arconim Constructora, SA

Introduction

Insolvency Law 141-15 is the principal legislation that governs insolvencies and restructuring procedures in the Dominican Republic. The Law was enacted in August 2015 but only entered into effect on 7 February 2017, after an 18-month transitory period. Furthermore, the rules of application of the Law 141-15 were signed into law by Decree No. 20-17 on 13 February 2017.

This means that the Dominican insolvency regulation has been valid for only two and a half years. Nevertheless, creditors and debtors are deciding to lean on the country's reorganisation and bankruptcy statue to protect their credits or assets.

To provide an illustration of the insolvency practice in the Dominican Republic to date, we will refer to the statistics provided by the court. In 2017 and 2018, there were 25 restructuring requests, out of which 19 were dismissed and only six were accepted; from January to July 2019, there were eight requests and only two were admitted by the court.

Of the eight active cases, five are currently in the liquidation phase (*Pawa Dominicana*, *Trevigalante*, *Mones Packaging Solutions Mopack*, *Caribbean Recycling* and *33 Renova*), two are still in the negotiation and conciliation phase of the restructuring process (*Munne* and *Arconim Constructora*) and one was rejected after the creditor who requested the liquidation filed a transactional agreement signed with the debtor.

Between 2018 and 2019, there have been eight appeals issued against decisions issued by the restructuring and liquidation courts, out of which one was not admitted, one was rejected, one was accepted, one is awaiting decision and the remaining four are still in the appeal process waiting for hearings dates.

Our firm is participating in seven of the eight actives currently active in the restructuring and liquidation courts. This article describes the main issues that we have experienced in our practice in this area.

The unfeasibility of nullity claims during liquidation

To provide some context for this section, we must briefly explain how our restructuring and liquidation regulation works.

The insolvency process is divided into three phases or processes:

- verification;
- reorganisation or negotiation; and
- liquidation.

The verification phase determines if the documents and information provided to the court allows it to confirm that the requirements to file a reorganisation or liquidation request are met and determine the economic and operational status of the company seeking its reorganisation or liquidation.

The reorganisation phase is led by the conciliator (equivalent to a trustee in United States or United Kingdom insolvency regulations) who must register all the credits, and prepare (if the reorganisation is requested by a creditor) or review (if the reorganisation is requested by the debtor) the restructuring plan.

Lastly, the liquidation phase is led by a liquidator who is in charge of the preparation of the liquidation plan, the realisation of the assets and the payment to the creditors.

It is important to note that according to the provisions of Law 141-15, creditors cannot request the involuntary liquidation of the debtor before attempting a reorganisation. However, upon a reorganisation request, the verifier and the trustee may recommend the immediate liquidation of the debtor under specific circumstances such as:

- lack of cooperation of the debtor during the verification or negotiation phase;
- when a reorganisation plan is not feasible under the particular circumstances of the debtor; or
- to avoid the increase of the debt and the diminishing of the debtors' assets.

Likewise, the debtor, the trustee or any recognised creditor could claim the judicial liquidation of the debtor if they fail to comply with the restructuring plan.

This is due to the fact that our insolvency regulation was conceived to promote and facilitate the reorganisation of insolvencies rather than force or facilitate the parties affected to go out of business. In practice, this entails that most of the actions and procedures created by the insolvency law, including nullity claims, were conceived mostly during the negotiation and conciliation phase of the reorganisation and not during the liquidation phase.

The problem with this situation in practice has been that in most cases the reorganisation has been unviable or impossible for multiple circumstances and, before a reorganisation plan is even attempted, the trustee or the verifier recommends to the court that the company is liquidated, thus skipping some phases of the process and, with it, the actions and procedures that the law has conceived for those phases, such as nullity claims.

The law establishes that ex officio, or upon petition of any creditor, the trustee may request the court the nullity of any transaction that took place two years prior to the reorganisation request when they constitute an unjustified dissipation of the debtor's assets. Transactions regarding public offering securities originated prior to the reorganisation request and with subsequent payment date are not subject to nullity action. Also, transactions involving the free transfer of assets or any other entered into by the debtor after the commencement of the insolvency proceedings may be annulled. Some transactions are expressly considered to be void, such as:

- the transfer of assets free of charge or at a price below market value;
- when the compensation given to the debtor or the creditor is notoriously superior or inferior than the compensation given or the obligation performed by the other party;
- partial or full compensations made by the debtor;
- payment of obligations not due by the debtor;
- the granting of new securities or increase of existing securities for debts originated prior to the reorganisation request with no justification;
- the transfer of property in favour of creditors that results in the payment of a higher amount to that received as a result of the liquidation; or
- transactions with related entities or companies where the debtor or any of the creditors serve as an administrator or are members of the board of administrators, or exercise

effective control of the company or represent 51 per cent or more of the capital, or are able to designate the majority of its board of administrators, among others.

Furthermore, Law 141-15 establishes the invalidity of any contractual clause that, within 60 days prior to the commencement of the negotiation phase or after the initiation of proceedings, aggravates the situation of the debtor or accelerates the enforceability of claims not due.

In addition, articles of the application of law 141-15 establish that if the trustee does not file the nullity claim within the time frame indicated in the law, the registered or recognised creditors that represent at least 10 per cent of the total liabilities of the debtor may file the nullity claim on behalf of the remaining creditors.

As explained above, the judicial liquidation may be initiated upon recommendation of the verifier, thus completely skipping the restructuring phase. This gives rise to a problem when there are transactions that are detrimental to the mass and subject to annulment since it may seem as if they are completely voided in any scenario other than the company's reorganisation, which is contrary to the purpose of the insolvency regulation.

Nevertheless, since the law is of very recent application and there is only limited case law regarding insolvency proceedings and none regarding nullity claims, we, as practitioners of the insolvency regulation, were hoping for a purposive approach in the interpretation of the law to fix this gap in the legislation.

It is for these reasons that in the case of the liquidation of 33 Renova SRL, we filed a nullity claim against two transactions that affected the mass of creditors and were annullable according to law 141-15, which were declared inadmissible ex officio by the court, for the reasons outlined below.

The reorganisation of 33 Renova SRL was filed by one of the creditors of the company, so the court appointed a verifier to confirm that the requirements to file the reorganisation request were met, and to verify the economic and operational condition of the company and render a report regarding the viability of a reorganisation. Given the lack of cooperation by the debtor and the impossibility of obtaining proper information, the court, following the recommendation of the verifier, ordered the judicial liquidation of the company, skipping the restructuring phase.

Considering this situation, and based on the principles of the law that seek efficiency, the maximisation of assets and transparency in all reorganisation and liquidation procedures, during the liquidation phase we filed a nullity claim against two transactions that were signed by the company and one of its creditors. The creditor that pursued the insolvency procedure also filed a nullity claim against one of the main documents that supported the credit of our client, which is the major creditor of the company.

After several hearings and the submission of multiple claims and statements of defence, on 9 September 2019, the court rendered two decisions declaring the inadmissibility of each nullity claim based on a literal interpretation of the law 141-15 that entailed that the nullity claim could only be filed by the trustee;[1] therefore, since in this particular case a trustee was never appointed, the court understood that the creditors – even when both had credits representing more than 10 per cent of the total liabilities of the mass of creditors – did not have active legitimation (ie, legal authority) to file a nullity claim.

In our opinion, this literal interpretation of the court contradicts the principles and purpose of the nullity claim, which the law, in its article 98, established as a mechanism intended to reconstitute the assets of the mass of creditors and ensure their equitable treatment. It is against the interest of the mass of creditors that an alleged creditor get paid during a liquidation procedure if its credit constitutes an annulled transaction that affected them and that is not supported on valid documentation. Unfortunately, these decisions are not subject to appeal since the law restricts the appeal to specific decisions.

Until now, the liquidator has not presented a valid provisional list of credits as it has been waiting for the decision of the court on these two nullity claims. This means that if the liquidator understands that the credit is not valid, the registration of the credit could be rejected. This decision could be appealed by the affected creditor. On the other hand, if the liquidator does register the credit, the last resource would be to file a revision claim against the provisional list of credits presented by the liquidator.

Nonetheless, this claim could also be dismissed if we take into consideration the decision rendered by the same court in another case. In the liquidation of Mones Packaging Solutions Mopack SRL – which was originally initiated as a reorganisation request – during the registration of the credits, the trustee received a request for the registration of the credit of Allied Mones Corporation SRL, a company related to the debtor, which was supported in 326 invoices that seemed to be produced specifically for the collection of an inexistent credit and to procure sufficient votes for the reorganisation or liquidation plan. Given this fact, the trustee recommended to the court the rejection of the credit and Allied Mones Corporation SRL filed a revision claim against the provisional list of credits.

After several hearings, the court rendered a decision[2] accepting the claim filed by Allied Mones Corporation claiming that the credit was supported in proper documentation, since the trustee did not file a nullity claim against the invoices that gave origin to the credit, thus its registration could not be rejected. Thus the interpretation of the court is that the only way to reject the registration of a credit that has supportive documentation – even if dubious – is through a nullity claim.

In summary, considering that in the case of 33 Renova SRL a trustee was never appointed, we will have to wait to see if the position of the court will withstand a revision claim against the provisional list of credit as it happened in the *Mones Packaging Solutions* case.

1 Tribunal de Reestructuración y Liquidación de Primera Instancia del Distrito Nacional. Resolution No. 974-2019-SREE-00018. File no. 974-2018-EREE-00012. 9 September 2019; Tribunal de Reestructuración y Liquidación de Primera Instancia del Distrito Nacional. Resolution No. 974-2019-SREE-00019. File No. 974-2018-EREE-00012. 9 September 2019.

2 Tribunal de Reestructuración y Liquidación de Primera Instancia del Distrito Nacional. Resolution No. 974-2019-SREE-00015. File No. 974-2018-EREE-00011. 18 July 2019.

The problem regarding the payment of the insolvency officers' fees

Creditors cannot request the involuntary liquidation of the debtor before attempting a reorganisation. On the contrary, debtors may initiate a voluntary liquidation and there are no material differences to proceedings opened involuntarily.

Nevertheless, even when this is a possibility, most cases prone to liquidation start with a reorganisation attempt from the debtor. This fact ultimately causes the court to appoint several officials, hence creating an important privileged credit caused by the fees of the officers involved. For instance, in some cases, the debtor requests a reorganisation, but the court designates a verifier before appointing a trustee and, upon the impossibility of a reorganisation, appoints a liquidator. This entails that a privileged credit for three different officers is automatically registered.

Regardless, even when the credit for the fees of the officers is considered privileged, and thus is of higher priority for collection and payment only preceded by labour liabilities, most professionals listed as potential officers for reorganisation and liquidation proceedings are very disappointed in how some courts treat the payment of their fees and expenses. Some have even asked to be withdrawn from the lists used by the courts to appoint the officials for the insolvency procedures.

The problem resides in the fact that most courts do not allow for advance payments of officers fees and expenses, and so all the officers involved in a reorganisation or liquidation procedure must bear all of the expenses incurred, including the fees for bailiffs required for subpoenas, expendable materials, fuel, travel expenses and so on, and fees for their auxiliaries and the hours incurred by them in the insolvency work, without having any certainty as to if, or when, they will get paid.

So far there are only two cases in which the courts have agreed to an advance payment of officers' fees: the reorganisation of Arconim Constructora, in which one of the authors of this paper is the appointed conciliator; and Pawa Dominicana.

In the first case, the trustee, Fabio Guzmán-Saladín, made a request to be paid his fees in advance after accepting his appointment, and the court accepted the request by issuing a decision. In the latter case, after the substitution of three appointed liquidators that conditioned the acceptance of their appointments on receiving an advanced payment of their fees and expenses, the court decided to hand the last appointed liquidator the remaining funds that were paid in advance by Pawa Dominicana to cover the expenses of the procedure. No resolution was issued by the court to sustain such a decision.

To put this in context, there are only two reorganisation and liquidation courts in the Domincan Republic: one in Santiago and the other in Santo Domingo, National District. There is only one case in Santiago and seven in Santo Domingo. While both courts are specialised in reorganisation and liquidation, each has a different approach when it comes to providing advance payment of officers' fees.

The Santiago court is inclined to a more purposive approach when interpreting the law and has established that an advance payment based on a provisional estimation of conciliator fees is possible even when the law provides that the trustee fees are determined when the restructuring plan is homologated or when the restructuring plan is terminated. The court understood that the fact that the fees cannot be liquidated in advance does not prohibit the court from making an advance payment, on a provisional basis, considering the range indicated in the law of between of 1 per cent and 3 per cent of the total assets of the debtor.

Furthermore, the court indicated that a law cannot escape the legal or sociological reality of the community for which the law is addressed, especially in a society where the practice of the legal profession is to require an advance payment for the services to be rendered. It also analysed the fact that the law provides that the expenses and fees of the verifiers are estimated at the beginning of their work and assumed by the debtor. In that line of thought, the court understood that, due to the reasonability, effectiveness and equality principles of law 141-15, an advance payment of the trustee's fees was possible and justified.[3]

However, upon request of an advance payment of the trustee's fees in the case of *Munne SRL*, the tenth courtroom of the Santo Domingo court rejected the request based on a literal interpretation of the law indicating that such request was inadmissible considering that a restructuring plan has not been homologated and the negotiation and conciliation phase had not concluded.

Another challenge regarding the payment of officers' fees arises in cases where an officer is removed following a decision from the Court of Appeal that annuls the judgment that ordered the judicial liquidation of the debtor. This situation occurs because, according to our insolvency legislation, the initiation of an appeal does not automatically suspend the conciliation and negotiation process, the judicial liquidation process or the obligations of the officers. However, the interested party could demand the provisional suspension of the process to the court. The problem is that so far the practice of parties and officers in these processes has been to not request the provisional suspension of the appealed decision to the court, and so the liquidation continues its normal course, generating expenses and fees for the liquidator involved.

For instance, in the liquidation cases of *Pawa Dominicana* and *33 Renova*, the decisions that rendered the court ordering the judicial liquidation of the companies were appealed and no one requested the suspension of the appealed decision. After several months, the Court of Appeal revoked the decisions that ordered the judicial liquidation of the companies based on procedural violations, thus revoking all subsequent decisions, including the ones that appointed the liquidator in each case. Neither the law nor its articles of application refer to this scenario or the specific event where a liquidator is removed for the annulment of the decision that ordered the judicial liquidation of the debtor.

This means that there are no legal provisions regulating this scenario, which brings a lot of doubts; for example, could the court appoint the same liquidator once it orders the judicial liquidation of the company after complying with all procedural formalities? The principles of procedural economy, efficiency and maximisation of assets would suggest a positive response,

3 Séptima Sala de la Cámara Civil y Comercial del Juzgado de Primera Instancia del Departamento Judicial de Santiago en funciones de Tribunal de Reestructuración y Liquidación de Primera Instancia. Auto No. 975-2019-TREE-00004. File no. 975-2019-EREE-00001. 7 August 2019.

while a literal interpretation of the law, which requires that officers are appointed at random, would suggest a negative response. We will have to wait until a new decision ordering the liquidation of companies is rendered to confirm the position of the court in that regard.

If the court decides on an automatic removal of the revoked office, another question may arise: which rules are going to be applied to liquidate the fees of the revoked liquidator and when will the revoked liquidator will get paid? The answer seems to be that the court should use the same rules used for the estimation of liquidator fees as established in the law, based on the complexity of the work performed by the liquidator until the moment of its revocation, and that its credit should be registered and will get paid once a liquidation plan is approved according to the priority set forth in the law.

Article 67 of the articles of application of law 141-15 establishes that within five days after the acceptance of a reorganisation request the debtor must deposit at the court the amount provisionally estimated by the court to cover the expenses of the procedure, which cannot be more than 0.5 per cent of the registered credits or the credits reported by the debtor on its request. Nevertheless, this amount is not being used by the courts to advance the expenses and fees of the officers, but rather to cover the publications in the newspaper that the law establishes as mandatory (except in the case of *Pawa* where the remaining funds were delivered to the liquidator who will have to transfer them on to the trustee following its revocation). The law does not regulate this situation either, and so the court will have to establish how and when those funds are going to be transferred, as well as the requirement to request a report from the previous liquidator to audit the administration and use of said funds.

In *Pawa*, after its revocation, the revoked liquidator requested authorisation from the court to use the funds under its administration to make some payments to cover the expenses and fees incurred until its revocation; however, the request was declared inadmissible by the court since it was submitted by the liquidator after it had been revoked. We understand that even when the bottom line of the decision was correct, since it could not allow such payments without any proper audit and report, and without making a final determination of the liquidator fees, it should have at least tried to address the underlying problems of the situation: that a person who no longer served as liquidator still held custody of the documents, funds and assets of the debtor.

Furthermore, our insolvency statute establishes that such amounts must be paid to a special account created for that purpose by the Judicial Branch; however, to this date, such account has not been created. Another complaint regarding this matter is that the court does not provide reports on how the funds are being used in spite of requests made to that effect by the debtor and the creditors.

In conclusion, there are multiple issues to be tended to by the insolvency courts of the Dominican Republic; however, considering the very limited period in which the law has been valid, it is too soon to talk about established criteria for any specific problems that have arisen so far.

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Fabio Guzmán Saladín is co-chair of the corporate practice. He has represented a wide range of domestic and international companies in mergers and acquisitions, banking, finance and project finance. He also focuses his practice in the areas of corporate bankruptcy, cross-border insolvency, financial investigation and asset recovery. He has represented several multinationals in complex bidding negotiations and government contracts in the country. Fabio is the leading attorney in the first major bankruptcy and restructuring case in the Dominican Republic, where he handles 90 per cent of all the restructuring procedures in the country.

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Founded in 1927, Guzmán Ariza is the largest law firm in the Dominican Republic, with seven offices strategically located to serve clients in every major business centre in the country. The firm's multilingual and multinational staff is equipped to assist international clients across a wide variety of practice areas.

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In summary

This chapter provides a broad view on the regulation of commercial insolvency proceedings in Mexico and the main reasons why, in the view of the author, the Concurso Law has not been a feasible and efficient alternative for Mexican companies in financial distress.

Discussion points

- Bondholders and collective creditors under the Concurso Law
- Lack of uniform interpretations and specialisation of the courts
- *Amparo* and other abundant available recourses in *concurso* proceedings
- Debtor-in-possession financing
- *Concurso* proceedings have not been a feasible and efficient alternative for companies in financial distress
- Creditors' ranking under the Concurso Law

Referenced in this article

- Ley de Concursos Mercantiles (Concurso Law)
- UNCITRAL Model Law on Cross-Border Insolvency
- *Vitro* case
- Instituto Federal de Especialistas de Concursos Mercantiles (Federal Institute of Specialists for Insolvency Procedures, IFECOM)
- Edgar Bonilla, Director of IFECOM
- Poder Judicial Federal (Federal Judiciary Branch)
- MORENA
- Andrés Manuel López Obrador

Introduction

Mexico has a relatively young insolvency regime, with few concursos having been brought to court and not much case law. The Concurso Law was enacted on 12 May 2000 and has had three amendments (in 2007, 2014 and 2019). It regulates the only commercial insolvency proceeding available in Mexico, which is known as *concurso mercantil* (concurso). Since 2000, close to 750 insolvency proceedings have been filed[1] (approximately 40 per year) – a very modest figure, with Mexico's economy being the 11th largest in the world.[2]

As the numbers reflect, most restructurings in Mexico are non-statutory out-of-court workouts. In the almost two decades of the Concurso Law regime, Mexican businesses have not embraced concurso as a means to resolve financial distress. The following factors contribute to this:

- excess of legal recourses available to challenge concurso court decisions;
- lack of specialisation from courts, which means a lack of clear jurisprudence;
- lack of a true and efficient debtor-in-possession (DIP) financing regime; and
- little transparency in the proceedings.

Any corporation, state commercial entity, individual with business activities[3] and trusts dedicated to business activities may be declared in concurso,[4] provided the insolvency test of the Concurso Law is met. The concurso must be filed before a federal district court, which will be in charge of the proceeding with the aid of different insolvency experts (visitor, conciliator and receiver) appointed by the Federal Institute of Specialists for Insolvency Procedures (IFECOM), an institute that serves as a quasi-judicial officer with certain responsibilities in the concurso proceedings. The Concurso Law defines the person declared in concurso as the debtor.

There is a general commercial insolvency proceeding and four different kinds of special concurso proceedings:

- the concurso with a 'pre-pack' or pre-filing restructuring plan;[5]
- the concurso of debtors that provide public services by virtue of a concession;
- the concurso of financial entities; and
- the concurso of auxiliary credit organisations.

1 IFECOM, https://www.ifecom.cjf.gob.mx/applications/aspx/reporte.aspx?op=1&fiSemIni=1&fiSemFin=39&fiSemestreC=1&fiAnioC=2000.

2 IMF, GDP, current prices, https://www.imf.org/external/datamapper/PPPGDP@WEO/OEMDC/ADVEC/WEOWORLD.

3 Individuals that do not carry out business activities are not subject to the Concurso Law. Civil insolvency proceedings are regulated by each of the state's Civil Codes. However, civil insolvencies (as opposed to commercial ones) are regulated deficiently and in practice are seldom used.

4 The only exception to said rule is when the debtor's total obligations are less than 2.3 million pesos. However, the debtor can expressly subject itself to the Concurso Law provisions.

5 The concurso with a pre-filing restructuring plan has to be filed with a restructuring plan pre-approved by the debtor and the creditors that represent more than 50 per cent of all of the debts. The main purpose of said concurso is to avoid the concurso declaration stage and the appointment of a visitor. After the concurso judgment, the proceeding continues as an ordinary concurso, where the restructuring plan will have to be judicially approved with the percentages foreseen for an ordinary concurso proceeding.

These special concursos can also be subject to the regulation of a specific law (eg, the Financial Entities Law). In 2019, the Concurso Law was amended to also include state-owned entities (aside from PEMEX and CFE, the petroleum and electricity state-owned entities) in liquidation proceedings. These entities are not subject to the insolvency test and shall be declared in liquidation with a governmental authorisation.

The concurso proceeding is divided into three stages, although the Concurso Law only clearly identifies two (conciliation and liquidation). There is one previous stage (the concurso declaration stage) and two main stages: the conciliation stage, which has the purpose of restructuring and preserving the company by means of a settlement agreement between the creditors and the debtor; and the liquidation stage, which has the purpose of liquidating the company's assets in order to pay creditors.

Concurso stages

Concurso declaration stage

The concurso declaration stage starts with the concurso petition filed by the debtor (who is not obliged to file for concurso), a creditor, the Federal Attorney General's Office or the Asset Management Institute. The filing party may submit arguments and evidence to prove the insolvency standards provided under the Concurso Law are met. Afterwards, the court opens up a visit stage. In the visit stage, a visitor is appointed to analyse the company's books and records. The visitor then has the task of making a report for the court establishing whether the company meets the insolvency standards (under Mexican law, 'general default of the company's payment obligations') for the court to declare the company to be in concurso.

The Concurso Law considers that a company is in general default of its payment obligations if it is in default regarding two or more creditors and meets the following requirements:

- out of the company's overdue obligations, the obligations that have matured for at least 30 days must represent 35 per cent or more of all of the company's obligations; or
- the company shall not have enough liquid assets and receivables[6] to support at least 80 per cent of its total overdue obligations.

When the insolvent company is the petitioning party, meeting only one requirement is sufficient. To file for concurso, the insolvent company must have approval from the relevant corporate body, and must file a preliminary plan and a settlement proposal, among other requirements. When a creditor or the Federal Attorney General's Office are the filing parties, both of the requirements mentioned above have to be met.

6 Liquid assets are defined by the Concurso Law as cash or deposits, deposits and investments payable within 90 days after filing for concurso, accounts receivable payable within 90 days after filing for concurso and securities of which sale and purchase are regularly carried out in the relevant markets and can be realised within a maximum of 30 days.

The Concurso Law provides different scenarios where insolvency (ie, 'general default of the company's obligations') is assumed. Examples of these situations include a lack of assets for attachment or a payment default with respect to two or more creditors. Under these situations, the burden of proof is shifted to the debtor to demonstrate that the insolvency standards are not met.

The debtor can also file for an imminent insolvency concurso when it presumes that within the next 90 days it will fall into general default of its payment obligations, in accordance with the requirements explained above.

After the *Vitro* case, which involved a big controversy over the way to take into account inter-company debt, the concurso proceedings of corporate groups were incorporated into the law with the 2014 amendment. This concurso can be filed when the insolvency of one company causes the insolvency of other companies in the group. These proceedings are heard by the same court, but they are handled separately and there is no substantive consolidation.

State-owned entities (aside from PEMEX and CFE, the petroleum and electricity state-owned entities) are not subject to the insolvency test and can be declared into liquidation with a governmental authorisation. Besides this, the liquidation proceedings will be ruled under the general rules of the Concurso Law, with the oversight of the Asset Management Institute.

After the visit, the court shall issue a judgment on whether the company meets the insolvency standards. After this judgment, the debtor enters either the conciliation stage or the liquidation stage. In the judgment, the court shall issue an automatic stay. Furthermore, the court may issue any injunction it deems appropriate, including the automatic stay, at any moment in the proceedings (including the court order in which the claim is admitted).

Conciliation

In the conciliation stage, a conciliator shall be appointed by IFECOM, and his or her task is to oversee the debtor's ordinary business operations, determine which credits shall be recognised and try to reach a settlement agreement between the debtor and its creditors.

In order to reach a concurso settlement agreement, which is the main goal of the conciliation stage, the settlement has to be signed by the debtor and the creditors whose credit represents more than 50 per cent of:

- the total amount of common (unsecured) and subordinated creditors; and
- the total amount of secured creditors and special privileged creditors that sign the settlement agreement.

If the subordinated credits represent at least 25 per cent of the amounts mentioned above, those credits shall be excluded from said amounts.

As discussed further below, apart from tax credits and 'other employee credits', any creditor can participate in the settlement agreement; however, only the common creditors can be crammed down. The cramdown provisions establish that the terms of the debt with non-consenting common creditors shall only be modified regarding the payment date (extension of time to pay) and the amount of the debt (debt discount), provided that:

- 30 per cent of the creditors of the same class sign the settlement agreement; and
- the conditions for non-consenting creditors are equal or more beneficial than the ones for the signing common creditors.

The settlement agreement can be vetoed by 50 per cent of the common creditors that did not sign the settlement agreement.

The conciliation stage may only last for 180 days, with the possibility of two 90-day extensions (360 days in total). The first extension shall be requested by the conciliator or 50 per cent of the recognised creditors. The second extension shall be requested by the debtor and at least 75 per cent of the recognised creditors. After this period has elapsed, if no settlement agreement is reached, the court will open the liquidation stage.

Liquidation

In the liquidation stage, a receiver is appointed. Upon the appointment of the receiver, the debtor's administration is handed over to the receiver. The mandate of the receiver is to liquidate all of the debtor's assets and to pay its creditors. However, the Concurso Law provides that the debtor and its creditors can still reach a settlement agreement in the liquidation stage.

The sale of the debtor's assets can be done either by the sale of the business as an ongoing concern or by selling individual or different groups of assets.

In order to preserve the value of the debtor's assets and sell the business as an ongoing concern, the receiver can continue running the company for as long as he or she deems appropriate.

The sale of assets or the transfer of the business as an ongoing concern must be done by either a public bidding or a court-approved alternative proceeding. Unfortunately, these liquidation proceedings are not very effective and sometimes the assets cannot be sold owing to procedural obstacles allowed under Mexican law by means of constitutional challenges (*amparo* proceedings)[7] of court orders to liquidate assets. The receiver can only avoid these proceedings in order to sell individual assets when he or she considers and later justifies to the court the urgency of selling said assets and the benefit for the estate – this naturally implies a high level of subjectivity, and courts in Mexico, not being specialised concurso courts, do not always understand business reasons justifying such a sale.

If all of the assets have not been sold six months from the date the liquidation was commenced, any person may file an offer to buy any asset, whose sale will later be submitted to a public bidding.

7 See footnote 8.

Creditors in the concurso proceedings

One of the main tasks of the conciliator in the concurso is the recognition of credits, which is done based on the books and records of the debtor and the credit recognition requests filed by the debtor's creditors. After the concurso declaration stage, any creditor shall put the conciliator on notice of its claim by filing the corresponding evidence justifying its debt holding. Afterwards, the conciliator is obliged to file a provisional list of credits with the court (which can be objected by the creditors regarding their ranking or the amount recognised), and later a final list of credits. When the final list of credits has been filed, the court has to issue the recognition, priority and ranking judgment. The debtor, any creditor, the intervenors (creditor-appointed supervisors charged with overseeing the conciliator or the receiver's conduct and the debtor's management during the proceedings), the conciliator, the receiver and the Attorney General's Office may appeal this judgment and eventually file an *amparo* constitutional review proceeding.[8]

The Concurso Law provides three opportunities during the procedure for the creditors to request the recognition of any claim:

- 20 days after the decision on whether the debtor meets the insolvency standards is published;
- in the period available to object to the provisional credits list; and
- in the period the creditors can appeal the credit recognition judgment.

Afterwards, no creditor will be allowed to request the recognition or object to the ranking or amount of any claim.

Regarding bondholders or any other type of collective creditors, the Concurso Law establishes that a common representative can file for credit recognition and represent the interests of the collective creditors in the concurso proceedings. However, each of the individual creditors shall be able to file for the recognition of its credit and act independently. For the concurso settlement agreement, the Concurso Law provides that the collective creditors shall agree a voting mechanism or convene a meeting where at least 75 per cent of the credits are represented, in order to determine the way that the collective credit will vote as a whole.

The Concurso Law does not expressly state who is entitled to act as a representative of a group of creditors in case the common representative was not appointed. The only provisions regulating representatives of collective creditors can be found in different statutes, the

8 The *amparo* proceedings are a type of constitutional review available for the protection of constitutional rights. There are two types of *amparo* proceedings: direct *amparo*, which is a one-instance proceeding against final and definitive resolutions; and indirect *amparo*, which is a two-instance proceeding against any other 'act of authority' (a Mexican term of art), if certain requirements are met. Mexican jurisprudence has determined that the recognition, priority and ranking judgment must be considered the final and definitive resolution for the purpose of the *amparo* proceeding (see Jurisprudence 1a./J. 78/2001 of the First Chamber of the Supreme Court of Justice, with the identification number 188077, and the isolated ruling II.2o.C.488 C of the Second Collegiate Civil Court of the Second Circuit, with the identification number 179363). Any other judgment and certain acts in the *concurso* proceeding can be reviewed by indirect amparo, after the ordinary remedies have been exhausted.

General Law of Negotiable Instruments and Credit Transactions, regarding bonds issued by companies, and in the Securities Market Law for instruments and trusts governed by the Securities Market Law.

To reach a settlement agreement and to determine the moment when a creditor shall be paid, the Concurso Law foresees different kinds of creditors, each with a different ranking. The ranking established by the Concurso Law is the following:

- employee credits for the previous year's salary and severance;[9]
- secured credits;
- special privileged credits (credits that are granted a special privilege by another Mexican law, such as social security credits and credits of a carrier);
- credits for the benefit and conservation of the debtor's estate;
- other employee credits and tax credits;
- common (unsecured) credits; and
- subordinated credits (debtor's related parties' credits).

Each of the credits shall be paid pari passu according with the ranking stated above, either by a settlement agreement or in liquidation.

As mentioned in the 'Conciliation' section, only common (unsecured) creditors may be crammed down in the settlement agreement and the settlement has to be signed by the debtor and the creditors whose credit represents more than 50 per cent of:

- the total amount of common and subordinated creditors (if they represent less than 25 per cent of the signing parties); and
- the total amount of secured creditors and special privilege creditors that sign the settlement agreement.

DIP management during the proceedings

In the conciliation stage, the Concurso Law provides that the administration will, in principle, remain within the debtor (as a DIP), with the conciliator overseeing operations. If the debtor is removed from the company's management, the conciliator will be responsible for its management. In the liquidation stage, the company's management always passes to the receiver.

Regarding the operation of the company, in the concurso declaration stage and conciliation stage, the company keeps operating in the ordinary course of business. Apart from the ordinary course of business, the debtor cannot enter new agreements or obtain additional loans without the consent of the conciliator and the court.

However, in the liquidation stage, the company will only remain in operation if the receiver considers it convenient to sell the estate or the business itself as an ongoing concern.

9 According to the Mexican Constitution and the Concurso Law, the employees shall take no part in the *concurso* proceeding and the injunctions issued in the *concurso* proceeding shall not be applicable to them regarding their credits for their last year salary and severance (see, isolated ruling: 1a. VIII/2012 (9a.) of the First Chamber of the Supreme Court of Justice, with the identification number 160245).

To oversee the correct performance of the conciliator or receiver's duties as well as the management of the debtor during the concurso proceedings, the creditors that represent at least 10 per cent of the recognised credits can appoint an intervenor.

Lastly, the company's management and other parties can be liable for damages caused to the debtor's estate. Moreover, management may also be criminally liable if it fraudulently aggravated the insolvency situation of the company or if it was responsible for certain other conduct sanctioned under the Concurso Law.

Contracts

At the outset of the conciliation stage, the conciliator shall decide which agreements will continue to be executed and which agreements shall be terminated.

The contractual counterparties have the right to request the conciliator to declare whether he or she will oppose the execution of a certain contract. If the conciliator responds that he or she will not oppose to the execution of such contract, the contract shall be executed or guaranteed by the debtor. Conversely, if the conciliator opposes or does not respond in 20 days, the contract may be terminated at any time.

If the debtor fails to perform any contract, the counterparty may request its termination through an ancillary proceeding.

In the liquidation stage, when the business is transferred by the sale of the business as an ongoing concern, the receiver has to notify the counterparties of the existing agreements so they can express whether they intend to continue with the corresponding contracts. If they do not respond within 10 days, the contracts will continue in execution.

Finally, the Concurso Law expressly provides that any clause that may aggravate the debtor's contractual terms and conditions as a consequence of filing for an insolvency petition against the debtor, shall be void.

Goods in possession but not owned by the debtor

Third parties that are owners of certain goods that are in the debtor's possession but not owned by the debtor shall ask the court for their 'separation'. The following requirements must be met:

- the goods must be in the debtor's possession;
- the goods must be identifiable;
- the property of the goods cannot have been transferred by a definite and irrevocable legal title; and
- the third party requesting the separation must be the legitimate titleholder.

Cross-border insolvency

The Concurso Law sets the terms, requirements and conditions of the recognition of foreign bankruptcy proceedings by Mexican courts. These rules are based on the UNCITRAL Model Law on Cross-Border Insolvency.

As is provided under the UNCITRAL Model Law, the Concurso Law only recognises two different foreign bankruptcy proceedings:

- foreign main proceeding: a proceeding taking place in the state where the debtor has its centre of main interests (COMI); and
- foreign non-main proceeding: a proceeding taking place in a state where the debtor has an establishment (but not its COMI).

Further developments of the Concurso Law – critics

One of the main issues with the Concurso Law has been the lack of uniform court interpretations and specialisation in concurso proceedings. Federal district courts that hear concurso proceedings are not specialised in concursos or commercial proceedings in general (even though the creation of specialised commercial courts has already been ordered).[10] Federal district courts also have jurisdiction of other subject matters such as *amparo*, civil and commercial proceedings, and in some cases, depending on the territoriality, even criminal, administrative and employment proceedings. It is a significant challenge for these generalist courts to have a clear grasp of the complexities involved in insolvency proceedings.

Performance statistics also play a deterring factor for federal judges, as concurso proceedings are considered equally to any other kind of proceeding, regardless of their sophistication and time-consuming nature. Moreover, there are, on average, only 40 concurso proceedings per year. Hence, the chances of courts developing a solid concurso practice is remote for the simple reason that there are not many concurso proceedings. Owing to these factors, many judges are not familiar or interested in the concurso regulation, which has caused a lot of diverging court interpretations and an unclear application of the law.

In addition to the lack of uniform court interpretations, other deterrents for the effective application of the Concurso Law have been the abundant available recourses for creditors and third parties to challenge concurso court decisions, as well as the excessive formalities of Mexican law, which can sometimes hinder the effectiveness of the proceeding and its goal to restructure the distressed company.

Another relevant issue, where Mexican legislation is noticeably behind compared to other jurisdictions relates to DIP financing. Even though DIP financing is regulated in the Concurso Law, in practice there has been little to no DIP financing in concurso proceedings to help rescue distressed companies. Understandably, lacking alternatives to obtain additional financing, companies in concurso find it challenging to restructure their finances. This is mainly because the Concurso Law does not grant super-priority to DIP lenders over secured creditors and other protected classes, such as employees. On top of this, perhaps the greatest obstacle to a DIP financing market is the Mexican banking laws, which provide different barriers and disincentives when lending to distressed or insolvent companies; namely, demanding almost

10 Article 53-bis of the Organisational Law of the Federal Judicial Branch.

1:1 reserves for any dollar granted in DIP loans, thus making it very expensive and unattractive for financial institutions to grant these types of loans when taking into account that they will not receive super-priority and the risk of not getting repaid will be high.

Lastly, IFECOM does not allow global corporations to be appointed as conciliators to guide a company through its concurso proceedings. Believing that sole individuals can address large concursos whose effects may even spread beyond Mexican borders is naive and irresponsible. Furthermore, IFECOM has thus far assumed an unwritten policy of not recommending the appointing of a conciliator who is not a member of IFECOM – this is seen as unrealistic from a business point of view.

Conclusion

For a regime that has lasted almost two decades, the Concurso Law has not presented a feasible and efficient alternative for companies in financial distress to restructure their debt. Moreover, the myriad resources (mainly by means of *amparo* constitutional reviews) available to creditors and third parties to challenge concurso court decisions make it extremely difficult for concurso courts to move forward with expeditious rulings to restructure businesses. In line with this is the need for specialised commercial courts. Federal district courts hear *amparo* cases that concern human rights protection – these courts, as constitutional courts, regard themselves as gatekeepers of citizens' human rights; they seldom have a deep understanding of the financial issues that are the main drivers behind business operations.

However, almost 20 years from the enactment of the Concurso Law, a window of opportunity to revise its content and deficiencies has emerged. The recently appointed new director of IFECOM, Edgar Bonilla, former VP of the Mexican Banking and Securities Commission, has voiced a clear goal to promote concurso proceedings, approach and support judges and seek to correct the deficiencies of IFECOM and the Concurso Law. On the other hand, in the 2018 elections, Mexico's current president Andrés Manuel López Obrador and his party, MORENA, won an overwhelming victory, upon which they now control the majority in congress. MORENA does not need consensus from opposition to pass legal reforms and has already reformed the Concurso Law (2019) to include state-owned entities as potential subjects of concurso liquidation proceedings (aside from PEMEX and CFE, the petroleum and electricity state-owned entities). With these factors, an opportunity emerges to revise and tackle the core flaws of the Concurso Law.

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Founded in 1986, Von Wobeser y Sierra, SC (VWyS) has a team of foreign and Mexican lawyers with international backgrounds who have handled the most complex and ground-breaking matters that are transforming the business landscape in Mexico and Latin America. VWyS is one of the foremost law firms for leading multinational and domestic clients that offers integrated legal solutions and unparalleled expertise advising in the establishment, operation and expansion of commercial interests in Mexico and Latin America.

VWyS's bankruptcy and restructuring practice is no different. This area is characterised for its presence in relevant domestic and international bankruptcy litigation and out-of-court restructuring, as well as for advising clients from the point of view of the creditors, the debtors and the insolvent entities.

With an integrated team of lawyers from different backgrounds, VWyS has a solid bankruptcy and restructuring practice. Under the lead of Diego Sierra, the team has been crucially involved in the most important and complex bankruptcy proceedings.

Diego Sierra's dual qualification to practise in Mexico and the United States has proven to be a unique feature that very few litigation practitioners have in Mexico. This is particularly relevant in an area such as bankruptcy where often the most complex bankruptcies are cross-border matters.

Key clients come from the insurance and finance industries, and other important sectors such as the automotive industry. VWyS has a particularly strong foothold in advising clients from the US and German markets.

In 2019, Global Restructuring Review recognised VWyS' insolvency practice as one of the top 100 practices worldwide.

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Debt–equity Conversions in Venezuela

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In summary

This chapter illustrates the legal, political and cultural issues that may arise in the context of any debt-to-equity conversion initiatives in Venezuela in which Venezuela's creditors acquire claims against the country or its instrumentalities in the secondary market and use them as a currency to make productive investments in Venezuela.

Discussion points

- Debt–equity swaps
- Swapping debt for local currency: a big non-starter
- Debt–equity swaps and foreign direct investment
- Debt–equity swaps and privatisations
- Valuation and reconciliation
- Discrimination of local investors and incumbents
- Market-timing issues
- Afterthought on possible critiques

Referenced in this article

- Bolivarian Republic of Venezuela
- Petróelos de Venezuela, SA
- National Assembly

Fui quod es, eris quod sum
(I was what you are, you will be what I am)

Introduction

In the sixteenth century, after 250 years of war, Florence bought Siena from the Habsburgs. That acquisition was settled via a debt-to-equity (debt–equity) swap. In the 21st century, a successful debt–equity swap programme could very well turn out to be an important element to help reduce Little Venice's mountain of debt and, more importantly, to promote much-needed investment.

Venezuela's oil and gas reserves as well as the considerable stock of businesses currently under government control could be deployed to pare down Venezuela's foreign external indebtedness, even after a successful renegotiation is completed, without further depleting Venezuela's extremely low foreign exchange reserves.[1] This programme could also help reignite foreign direct investment into the country.[2]

Aggregate claims against Venezuela, Petróleos de Venezuela, SA (PDVSA) and other government-owned entities have been estimated as high as US$175 billion,[3] so even if foreign direct investment starts flowing into the country en masse and oil exports are restored to levels last seen almost a decade ago, the resulting foreign currency proceeds will amount to only a fraction of Venezuela's mountain of debt. In our view, a portion of Venezuela's debt will have to be converted into productive investment in order to restore the country's viability and debt sustainability.

Debt claims could be used as currency to pay for hydrocarbons exploration and exploitation rights, bonus payments to enter into new or existing oil joint ventures, to acquire additional participations in existing oil joint ventures, and pay for oil and gas royalties.

1 Venezuela's foreign exchange reserves are owned by the Central Bank, which is a public sector instrumentality with autonomous personality from the Republic.

2 See: Wallenstein Steven M; Silkenat, James R, *Investment Funds and Debt Equity Swaps: Broadening the Base of a New Investment Tool*. (1988). The authors explain that: 'Chile, which has developed one of the most sophisticated debt–equity mechanisms, has retired from 1985 to the end of 1987, approximately US$4 billion from of its approximately US$20 billion in foreign debt'.

3 See: Cooper, Richard J; Walker, Mark A. *Venezuela's Restructuring: A Path Forward* (2019). This amount includes the Republic's and PDVSA's bonded debt, indebtedness due to multilaterals and the China Development Bank, arbitration claims and trade debt due to suppliers and contractors.

In addition to the oil and gas sector, as a result of government policies deployed over the past two decades,[4] the Venezuelan public sector owns or controls businesses in virtually all sectors of the economy, including agribusinesses, airlines, aluminum, banks, brokerages, cement, commercial and residential real estate, dairy, forestry, float glass, hotels, insurance, iron ore, mobile telecommunications, power utilities, staples, steel mills, supermarket chains as well as vast tracts of land that can be used to produce anything from sugarcane to cattle.

This chapter tries to illustrate the legal, political and cultural issues that may arise in the context of any debt for equity conversion initiatives in Venezuela in which Venezuela's creditors acquire claims against the country or its instrumentalities in the secondary market and use them as a currency to make productive investments in Venezuela.[5]

Debt–equity swaps

A debt–equity swap would require the holders of claims against Venezuela or PDVSA (eg, bonds, promissory notes or other debt claims, arbitration awards, judgments or commercial receivables) to voluntarily exchange them for other assets, such as Venezuelan currency, internal debt securities, shares or other equity interest in joint venture companies or other state-owned companies, debt or equity securities issued by an investment vehicle or oil or gas licenses.[6] More specifically, under a debt–equity swap programme, the holder of defaulted

4 See: Venezuela's most recent 18-K filing with the US Securities and Exchange Commission on 21 December 2017 'President Chávez announced a plan in 2007 to nationalize various strategic areas of the economy in order to further state control of the development of these sectors in Venezuela, including the acquisition of majority control of joint ventures in the Orinoco Oil Belt (heavy oil projects that had been authorised in the 1990s) in connection with the development of those resources. This initiative also extended to certain electricity and telecommunications companies that had been operated and controlled by the private sector through a process of negotiated acquisitions with the controlling shareholders of those entities. In 2008, the Government nationalized companies in the steel and cement industries to provide for better control of inputs for construction and infrastructure'. 'For a summary of Venezuela's nationalization drive under the Chávez and Maduro administrations'. https://www.sec.gov/Archives/edgar/data/103198/000119312517376486/d505622dex99d.htm.

5 See: Wallenstein and Silkenat: 'Debt conversion activities can be divided into several broad categories. The most prevalent activity is straight swapping of acquired debt for equity investments in local enterprises, for other sovereign debt or for local currency. A sub set of this kind of activity utilizes pooled investment vehicles or investment funds, in which a consortia of resident and non resident banks with the same general objectives pool a portion of there loans to form a national "investment trust"'. See Mitra, Aditya, Ortiz Andres, Botchway, Bernard, Pereira, Evaristo, O´Neill Shane, Curtis, Will, *Oil for Debt: a unique proposal for the unique challenge that is restructuring Venezuela's debt* (2018). The authors analysed debt–equity swaps during the 1980s when emerging market debt, specially Latin-American debt, was represented by bank debt and not bonds. To create a national investment trust, it has been proposed to obtain exit consents of bond holder that agree to exchange their bonds for participation into such a trust.

6 See: Moye, Melissa, 'Overview of Debt Conversion'. *Debt Relief International Ltd.* Publication No. 4 (2001). Cited in Radha, Saliesh S, *Debt Equity Swaps: Structures, Impacts and Perspectives*. (2015) 'A debt swap involves the voluntary exchange, by a creditor with its debtor, of debt for cash, another asset or a new obligation with different repayment terms. The economic rationale for debt swaps is based in the willingness of a creditor to accept less than face value of debt and of the debtor to make payment at a higher value (than market value), but usually less than 100 per cent of face value of the original debt'.

Venezuela or PDVSA bonds that, at the time of writing, traded at huge discounts, would agree to voluntarily exchange the bonds for the productive asset using an exchange ratio mutually agreed between the claimholder and the Venezuelan state-owned entity that holds the shares or the asset.

Under the current Hydrocarbons Law,[7] oil exploration and production activities can only be carried out by:

- the Venezuelan state;
- companies wholly-owned by the Venezuelan state; or
- joint venture or mixed companies in which the state retains control of its decisions through the ownership of more than 50 per cent of its capital (the Oil JVs).[8]

To implement a debt–equity swap in the oil sector, it is likely that the Hydrocarbons Law will need to be amended to:

- allow payments for shares in existing or new Oil JVs with reconciled debt claims against Venezuela or PDVSA;
- authorise the use of reconciled claims for entry bonus payments and bid bond payments;
- permit private ownership of more than 50 per cent of Oil JVs' capital stock;
- enable Oil JVs or private enterprises to market crude internationally;
- reduce the total government's take from the current 80 per cent to levels that are more in line with international standards; and
- allow the payment of royalties with reconciled claims.

If the original bond or claim is directly against the Republic of Venezuela and the Republic of Venezuela holds the productive assets being swapped, then the swap should automatically vaporise the claim. If the bond or claim is against PDVSA or any other public sector entity and the productive asset is held by the Republic of Venezuela, then the Republic of Venezuela, upon exchanging the productive asset for the claim or shortly thereafter, should cancel the claim in its capacity as the new creditor of the public sector entity debtor. Conversely, if the bond or claim is against the Republic of Venezuela and the productive asset is held by a different public sector entity, upon exchanging the productive asset for the claim, or shortly thereafter, the public sector entity party to the swap should cancel the resulting claim against the Republic of Venezuela. It would be important to articulate these debt cancellations and assignments on an omnibus agreement among the relevant public sector entities to help prevent the bonds and other claims that are intended to be cancelled from somehow finding their way

7 Article 22. Originally published in the Official Gazette number 38,443 dated 24 May 2006, republished with corrections in the Official Gazette number 38,493 dated 4 August 2006.

8 There are two draft proposed amendments to the Hydrocarbons Law that would allow private ownership of companies in the oil sector of more than 50 per cent. The above explanation applies mutatis mutandi to the acquisition of shares of an oil project company in Venezuela representing more than 50 per cent of its capital stock.

back to the secondary market and hence defeat the goal of debt reduction.[9] Venezuela's and PDVSA's bonds are book entry securities; however, most of the other claims are represented in physical documents, such as commercial invoices and promissory notes, and should therefore be formally cancelled.

The holder of the bond will want the bonds to be exchanged at par and the Venezuelan government will want the bond-to-share exchange ratio to be closer to the bond's market value. The final exchange ratio will probably lie anywhere between the market value of the bonds and their par value. The economic driver for Venezuela would be to retire the debt at a price that is lower than its par value and the debt holder's incentive would be to exchange the debt for equity that has economic value higher than the cost basis of the cancelled debt acquired in the secondary market.[10]

A debt–equity swap programme's success in reducing Venezuela's external obligations will depend on whether the programme harnesses the discount in the secondary market of the exchanged debt.[11] Successful debt–equity swap programmes are very difficult to achieve because of the countervailing forces represented by the simultaneous desire to reduce debt, protect foreign reserves and promote foreign direct investment.

The long-term success of the programme will also depend on Venezuela's growth prospects, debt sustainability post-restructuring and its ability to generate foreign currency capital inflows and export proceeds. Ultimately, the participating investors will be replacing one type of claim (a debt claim) for another (an equity claim with repatriation rights).[12]

9 Cancellation of the bonds would need to comply with the respective indentures (PDVSA) and Fiscal Agency Agreements (the Republic). The Republic is tax exempt and will not be faced with any gift tax or income tax issues in Venezuela as a result of the debt cancellations. Other public sector entities are not legally exempt from the gift or other taxes; therefore a debt exoneration decree could be enacted to exempt the cancellations and the exchanges from income and gift taxes in Venezuela.

10 The Organic Financial Management Law of the Public Sector published in the Official Gazette number 6.210, dated 30 December 2015, allows the payment of taxes with bonds issued by the Republic that have matured (a su vencimiento) at par if the Annual Indebtedness Law under which the bonds were issued allows such payment (art. 89). This article also reads that it is not clear if at maturity would mean stated maturity or maturity by acceleration. Also, Venezuelan legal scholars do not consider that the royalty qualifies as a tax (tributo) they consider royalties as compensation for the right to exploit oil or gas.

11 See: Krugman, Paul R. 'Market Based Debt Reduction Schemes', NBER Working Paper. p. 22 (May 1988). Important economists are sceptical about a debt–equity programme's ability to effectively reduce debt because it is 'widely expected that direct foreign investors will be allowed to repatriate earnings and/or use their profits as they wish within the debtor nations, even if theses countries are failing to repay debts fully'.

12 See: 'Statement of Venezuela Creditors Committee' dated 9 July 2019, page 4. It was proposed that 'The possibility for debt/equity type swap programs under which participants can elect to acquire assets from the Government in exchange for existing debt and a legally binding commitment to invest funds to develop the assets acquired'.

Swapping debt for local currency: a big non-starter

Debt–equity conversion programmes were originally implemented by Latin American debtor countries during the 1980s. All of them involved the conversion of debt into local currency or internal debt that would later be used to acquire equity or pay local suppliers and general contractors.[13]

In the case of Venezuela, exchanging eligible claims for local currency will probably not be economically attractive for investors given Venezuela's history of hyperinflation and maxi-devaluations. In fact, Venezuela attempted to implement a debt–equity swap programme in the late 1980s but was largely unsuccessful. The programme involved the exchange of financial indebtedness for bolivars and, given that at the time (and at many times during its history) Venezuela had a dual foreign exchange system, where an official controlled rate was substantially more expensive vis-a-vis US dollars than the floating – sometimes grey market – exchange rate, there was no incentive to convert debt acquired in the secondary market and then exchange it for expensive bolivars at the official rate, when dollars, let alone debt securities, could be exchanged for local currency at the 'better' grey market rate.

In addition, Venezuela's monetary aggregates are minimal when calculated in dollar terms.[14] Therefore, the exchange of even a small fraction of the US$175 billion debt into bolivars will have catastrophic inflationary effects.[15] Likewise, it does not seem advisable to convert foreign external indebtedness into internal debt (ie, financial indebtedness denominated in local currency issued by the Republic of Venezuela or by PDVSA in the local capital

13 See: Wallenstein Steven M; Silkenat, James R, *Investment Funds and Debt Equity Swaps: Broadening the Base of a New Investment Tool*, p. 16 (1988). 'Brazil has limited the volume of transactions primarily to a monthly auction of the equivalent of US$150 million in an effort both to gauge the effects of the conversions on the monetary supply and to build a more rationalized national mechanism for the regulation of the conversion process. By contrast, Chile has enacted a system in which the Central Bank issues government bonds instead of pesos, which are traded in the local securities market. The bonds are then traded at a discount because they pay a rate of interest that is slightly less than the "UFR rate". From the standpoint of monetary pressures, money is not created immediately through this system because "new money" is not injected into the economy. The money does, however, go to private investment instead of to the government. There is also the inverse concern in certain Latin American debtor countries (and among some Western critics of the conversion process as well) that debt–equity conversions do not inject "fresh money" into the economies, but merely subsidize investment that would have been made in the absence of the debt–equity mechanism. Such concern has been particularly apparent in Argentina, where laws governing the debt–equity conversion process require investors to make additional local investments in connection with their debt–equity transactions.' In 1985, Mexico exchanged non-performing loans due to American Express Bank for internal debt securities at a discount which were later used by the bank to pay local building contractors of hotel developments in Mexico.

14 As of September 2019, Venezuela's M1 was 14.7 trillion bolivars equivalent to US$736,290,113 at the foreign exchange rate of US$1.00 = 20,430.10 bolivars.

15 Foreign direct investment could also have an inflationary effect, but foreign direct investment can be made with machinery and equipment imports and if made in cash it increases the capital stock of the country.

markets). This would not help reduce Venezuela's debt stock and could potentially stress Venezuela's foreign reserves in the future when and if the holders of the internal debt wish to repatriate the principal repayments and interest payments paid on the local debt.[16]

Hence, in our view, any successful debt–equity swap will need to involve the direct swap of debt for equity investments without having to go through an initial exchange into bolivars (or any future local currency). In fact, a Venezuelan debt–equity swap programme would have to be the cornerstone of a privatisation programme. It will not be sufficient to implement a programme similar to those implemented in the 1980s by Argentina, Brazil, Chile, Mexico and Venezuela itself. The programme will ideally have to be placed within the larger context of a titanic reconstruction effort.

Debt–equity swaps and foreign direct investment

Debt–equity swaps will not increase Venezuela's foreign exchange reserves. However, they have the potential to help reduce the country's and PDVSA's aggregate debt and increase the country's capital stock.[17] If the programme is well executed, it can also help promote foreign direct investment that in turn will increase the country's reserves, capital stock and export capacity.[18]

An interesting structure to explore would be to swap eligible claims (eg, claims that have been reconciled or that have been exchanged for new bonds issued by Venezuela in a restructuring) for capital goods outside Venezuela that are then imported into Venezuela to be deployed in projects. This structure would not have an impact on foreign reserves, would increase the country's capital stock and would not have inflationary effects. The debt reduction, however, would be a function of the discount of the new claims and any debt relief agreed in the restructuring.

Foreign investors will hesitate to invest in Venezuela (whether via debt–equity swaps or directly through capital contributions) if they feel that capital controls may be around the corner. This is one of the limitations that affect debt–equity swaps in general. As explained by Paul Krugman, 'once one realises that the ability to reduce net obligations through debt

16 As an aside, the conversion of foreign external indebtedness into internal debt does not require approval from the National Assembly which is Venezuela's legislature (Art. 99, Organic Financial Management Law). All other indebtedness generally require appropriation in the annual indebtedness law.

17 We use the economic definition of the term capital stock, namely: the aggregate of a country's plants, equipment and other productive assets.

18 See: Krugman, Paul R. 'Market Based Debt Reduction Schemes', NBER Working Paper, p. 22 (May 1988). It has been said that 'a debt–equity swap neither provides a capital inflow nor cancels a country's obligations. The foreign investor does not bring foreign exchange into the country, since it is the country's own debt that is presented to the central bank; this there is no capital inflow. The country's obligations are not being cancelled; the foreigners acquire an equity claim on the country to replace their previous claim. What has really happens is securitization. The country has exchanged a new kind of liability for some of its existing liabilities'.

equity swaps depends on seniority of equity (which is itself a fairly weird idea), the limitations become apparent.’[19] The counter argument is that payouts on equity are contingent on there being profits.

There will be a tug-of-war among debt investors and equity holders. Foreign external debt holders may be amenable to capital controls, particularly if they feel that the controls will help increase the country’s foreign currency reserves available to service debt, at the expense of the reserves available for foreign equity investors to repatriate capital distributions.

On the other hand, Venezuela has entered into multiple bilateral investment protection treaties which protect foreign investors’ repatriation rights.[20]

Any debt–equity programme will have to be undertaken in the context of a much broader macroeconomic adjustment programme that massively restores confidence.

Debt–equity swaps and privatisations

Venezuela has a privatisations law that dates from 1997.[21] Under this law, the sale of shares in ‘basic’ or ‘strategic’ companies requires approval from the National Assembly.[22] The sale of shares in other government-owned companies requires the approval of a privatisation policy by the President and the Finance Commission of the National Assembly.[23] We draw attention to this long forgotten law because it will require that the country’s leaders take complete ownership of the programme, as well as the required structural reforms, and shepherd them through the required regulatory approvals.[24]

Pursuant to the privatisations law, the sale of shares in state-owned companies (ie, companies in which the Republic of Venezuela directly or indirectly owns 50 per cent or more of their outstanding capital stock) must be carried out either through a public auction or through

19 See: Krugman, p. 23.

20 The treaties have been entered into with Argentina, Brazil, Barbados, Canada, Chile, Costa Rica, Czech Republic, Denmark, Ecuador, France, Paraguay, Peru, Portugal, Spain, Sweden, Switzerland, United Kingdom and Uruguay.

21 Official Gazette number 5.199, dated 30 December 1997. This law was never abrogated by the Chávez or the Maduro administrations. In fact, the Public Assets Law (Ley de Bienes Públicos) specifically carves-out from the provisions applicable to the sale of public assets, including shares of government-owned companies, the sale of assets undertaken within the context of privatisation programmes.

22 The terms ‘basic’ and ‘strategic’ are not defined in the 1997 Privatization Law. While the term ‘basic’ have historically been construed referring to the iron, steel, aluminium and other companies in the Guayana region of southern Venezuela, the term ‘strategic’ has not been defined.

23 Venezuela’s legislature prior to the Constitution approved in 1999 was a bicameral legislature with a Senate and Chamber of Deputies, each of which had their own finance committee. The National Assembly only has one chamber and one finance committee. In our view, approval of the President’s privatisation policy by the permanent finance committee of the National Assembly would be sufficient.

24 Article 13.1, Privatization Law. Government-owned company’s employees and pensioners have a statutory preferential right to acquire up to 20 per cent of the capital stock of the entity when it is privatised.

one of the mechanisms regulated under the Venezuelan Securities Markets Law, namely an initial public offering (IPO).[25] In our view, public auctions and IPOs would be desirable for their transparency and price formation mechanics.

We like to believe that the privatisation of businesses can be handled smoothly, successfully and would very likely be understood by the general population. In fact, there are myriad companies that are now in the government's hands that were originally privately owned companies.[26]

With respect to the oil and gas sector, allowing majority ownership of Oil JVs by the private sector and later allowing the use of debt instruments or reconciled claims as a currency of payment for shares, or other forms of participation in the oil and gas sector, will require amendments to the legal and regulatory framework and a cohesive effort by enlightened leaders to take ownership of the programme and convince their respective constituencies of its benefits.

Valuation and reconciliation

The market value of bonds is easily determined because there is a secondary market for bonds in distress. However, the valuation of the businesses eligible for a debt–equity swap will be challenging.

To add another layer of complexity, out of the estimated total of claims against Venezuela and PDVSA, only approximately US$70 billion arise from international debt securities or other forms of foreign external indebtedness owed to international financial institutions. The rest relate to claims that arise from unpaid commercial invoices, executory contracts, physical promissory notes and arbitration awards rendered in favour of expropriated private investors. This means that a debt–equity conversion programme will need to be preceded by an immaculate reconciliation process. Furthermore, the valuation of business enterprises that have only generated local currency income over the past few years, that operate in an economy whose GDP is a fraction of what it was only five years ago and that require sizable capital expenditures, will be very challenging.

Therefore, a transparent valuation mechanism that is agreed upon by all the relevant stakeholders will be required to improve the political viability of the programme.[27]

25 Article 3, Privatization Law.

26 See footnote 4 above. The majority of the sectors and companies that were nationalised during the Chávez and Maduro administrations were originally private enterprises and may still have a 'private sector DNA'.

27 During the 'apertura petrolera' process carried out by PDVSA during the 1990s, PDVSA successfully held three bidding rounds for oil operating agreements for mature oil fields and profit sharing agreements for new oil projects. As a result of the process, PDVSA partnered with international and Venezuelan investors in 19 oil operating contract projects, four vertically integrated upstream, midstream and downstream projects for extra heavy oil and three profit sharing contracts for conventional crude. Venezuela's oil production increased to three million barrels a day.

Discrimination of local investors and incumbents

The temptation may exist to disallow local holders of bonds and other claims to participate in debt–equity swap programmes.[28] This temptation will arise to appease criticism that the people who 'took their money out' should not be allowed to buy productive assets in Venezuela at discounted prices.[29] In our view, this would be a mistake. Discrimination will open the programme to legal and political challenges. Venezuela needs closure and a clean slate to grow and move on. In addition, it is estimated that up to 25 per cent of the aggregate principal amount of Venezuela's and PDVSA's bonded debt is held by Venezuelan investors, including widows and orphans. Also, holders of expropriation claims could hardly be seen as having taken their money out of Venezuela and should hence not be discriminated against. This is where the reconciliation process will also play a fundamental role.[30]

Market timing issues

As explained, the viability of debt–equity swaps depends on whether the investors are able to take advantage or harness the discount of the eligible claims in the secondary market. Deep discounts have the potential to incentivise investors to capitalise discount debt purchased already at a discount. Lower discounts will have the opposite effect. Then again, if eligible claims are not trading at a discount, it will likely be because the country's debt sustainability and overall economic outlook have substantially improved.[31] One criticism lobbed at debt–equity swaps is that they subsidise investment that would have been made anyway without the discount. Although Venezuela's long-term outlook may be encouraging, in our view, jump-starting investment in the short term will require many forms of incentives.

One scenario is that only bonds and reconciled claims would be eligible to participate in the debt–equity swap programme. Presumably, there will be a secondary market for reconciled claims that would probably trade initially at a discount from their nominal value, specially during the period from their reconciliation until a new instrument or instruments are voluntarily exchanged for the reconciled claims in the context of a restructuring. In this case, interested investors could purchase reconciled claims at a discount and try to harness the discount when they exchange them for productive assets or shares in companies in Venezuela.

28 See: Radha, p. 11. Chile has been the only country in Latin America that completely allowed local debt holders to participate in debt–equity swaps.

29 See: Radha, p. 11. 'Preventing local investors from participating in the debt–equity programs would reduce the volume of investment produced by those programs. A swap program open to all investors would lead to broad investor confidence in the country, which remains the major problem in all debt-ridden low-income countries.'

30 Non-discrimination does not mean allowing bad actors to cleanse ill gotten gains via debt equity swaps.

31 Under more normal circumstances, the government itself could buy back bonds, cancel them or hold them in treasury and resell them at higher prices or replace them with lower yielding debt.

This could also be achieved after the new instruments are issued as a result of the restructuring if they trade at discounts in the secondary markets. Otherwise, there will not be incentives for investors to participate in any debt–equity swap programme.[32]

Conclusion

A debt–equity swap programme for Venezuela could have the potential to reignite the country's economy and could also help reduce the country's debt stock. Such a programme will be confronted by numerous political and idiosyncratic challenges that will call for an immaculate reconciliation, valuation and execution process. The programme will pose a philosophical tug-of-war between those allowing investors to harness the secondary market discount of eligible claims and those permitting a fair exchange of productive assets currently owned by the government.

Debt–equity swaps will not work standing alone. They need to be one of the several items on the menu for a comprehensive debt restructuring and, more importantly, they will need to walk hand in hand with the structural reforms that will promote reconstruction of the country's infrastructure, privatisations and foreign investment. Leaders must take full ownership of the programme.

Afterthought on possible critiques

The following critiques to debt–equity swap programmes should be anticipated in Venezuela:

- The programme subsidises investments that would otherwise be made anyway with cash or capital goods.
  - Rebuttal: The country's capital stock increases and new investments will come as a result of the programme. Better management, know-how and modernisation will benefit the economy.
- There is no real foreign investment.
  - Rebuttal: The country's capital stock increases and new investments will come as a result of the programme.
- There is no debt reduction. Venezuela is exchanging debt liabilities for equity liabilities.
  - Rebuttal: Debt claims are fixed income claims with stated maturities and interest payment dates. Equity's income is variable and inherently riskier. Maximising shareholder value is preferable than capital distributions.
- Investors should commit to make additional real money investments to be eligible to participate.

32 If the reconciled claims or the new instruments do not trade at a discount that is attractive enough to entice investors to use them as currency in a debt–equity programme, that would probably mean that Venezuela is out of the woods and could delay or scrap the programme or that any privatisation initiatives can move forward without the need to allow participating investors to opportunistically harness discounts given the country's viability and debt sustainability.

  - Rebuttal: This has been done in other jurisdictions with limited success. If the macro-economic outlook improves, new investment will flow into participating sectors and other sectors.
- Capital repatriations should be subject to compliance with additional investment requirements.
  - Rebuttal: Investors will hesitate to invest via the programme or otherwise if they believe that capital controls are around the corner.
- The programme promotes the transfer to foreign investors of strategic industries.
  - Rebuttal: The country needs strategic partners to promote reconstruction and growth.
- Strategic or valuable industries are being sold at bargain basement prices.
  - Rebuttal: Auctions and initial public offerings will ensure fair prices and valuations.
- Local investors should receive preferential treatment. Foreign investors should partner with local investors to participate in the programme.
  - Rebuttal: A transparent and competitive process is the only way to ensure its success. Preferential treatment will tarnish the programme and may give rise to challenges. Forced marriages are very complicated.

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Chambers and Partners awarded D'Empaire with the distinction of Venezuelan Law Firm of 2009, 2010, 2012, 2015, 2016, 2017 and 2018 in the first, second, fourth, seventh, eighth and ninth edition of its Latin America Awards for Excellence. In 2011 and 2014, D'Empaire was recognised by *Chambers Latin America* with the 'Client Service Award', together with six distinguished Latin American law firms. D'Empaire was the first Venezuelan law firm to receive this award. In 2013, D'Empaire's managing partner Fulvio Italiani was honored with an award for 'Outstanding Contribution to the Legal Profession' at the Chambers Latin America Awards for Excellence.

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US: Chapter 11

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In summary

This chapter addresses commercial bankruptcy practice in the United States, which is governed by Chapter 11 of title 11 of the United States Code. The focus of Chapter 11 is assisting a distressed company to reorganise its debts to emerge as a going concern, or liquidate its assets as part of an orderly wind-down. The article highlights the key benefits available to a Chapter 11 debtor and describes the various stages of a case, including statutory requirements, and types of plans. The article concludes with a brief discussion of Chapter 15 of the Bankruptcy Code utilised by foreign entities in cross-border restructurings.

Discussion points

- Commencement of a Chapter 11 case
- Debtor's disclosure obligations
- The automatic stay
- Treatment of executory contracts and unexpired leases
- Cash collateral during a Chapter 11 case and debtor in possession financing
- Asset sales
- Claims resolution process
- Avoidance actions
- Types of Chapter 11 cases
- Introduction to Chapter 15 (cross-border restructurings)

Referenced in this article

- Title 11 of the United States Code (Bankruptcy Code)
- United States Trustee
- Pre-packaged bankruptcy case
- Pre-negotiated bankruptcy case
- Freefall bankruptcy case
- United Nations Model Law on Cross-Border Insolvency

Introduction

Title 11 of the United States Code (the Bankruptcy Code) governs bankruptcy and insolvency cases in the United States. Chapter 11 of the Bankruptcy Code provides the framework for companies to reorganise and restructure their business operations and debt, while simultaneously continuing to operate in the ordinary course, usually with existing management in place, and thus to maximise value for all economic stakeholders. Chapter 11 can also be used by a business seeking a controlled and orderly liquidation of its assets, as opposed to a Chapter 7 liquidation where a trustee is appointed (immediately displacing the company management) to direct and administer the liquidation. Generally, except in cases of fraud, dishonesty, incompetence or gross mismanagement, the existing management and the board of directors continue to control the business and property, known as the debtor in possession. In a bankruptcy, the debtor in possession and its board of directors have a fiduciary duty to protect the interests of creditors, not just the shareholders.

The concept of a debtor in possession makes Chapter 11 attractive because it allows current management with historical knowledge and familiarity with vendors and customers to continue to manage the business and guide it through the bankruptcy process. Furthermore, in the course of operating its business, the debtor is free to engage in ordinary course transactions without seeking court approval. On the other hand, transactions that are outside the ordinary course of the debtor's business (such as selling significant assets or obtaining credit) must be court-approved, after requisite notice to parties in interest and opportunity for such parties to object. As a practical matter, a debtor will usually seek court approval of significant transactions out of an abundance of caution, even if the transaction may otherwise be considered in the ordinary course of business.

The three primary goals of Chapter 11 of the Bankruptcy Code are to provide a distressed company with:
- a fresh start, including allowing for continued business operations during the restructuring process;
- breathing room from creditors' collection efforts and the continuation or commencement of litigation against the debtor, known as the automatic stay; and
- the ability to make orderly distributions to creditors in a fair manner consistent with the priority scheme set forth in the Bankruptcy Code.

The key benefits of filing a Chapter 11 bankruptcy case include, among others:
- the imposition of the automatic stay to provide protection from creditors and time to restructure financial affairs, including completing a sale or conducting an orderly wind-down;
- the power to reject burdensome contracts and leases;
- the ability to sell assets free and clear of liens, claims and encumbrances; and
- the possibility of 'cramming down' a Chapter 11 plan over objecting parties and binding the non-consenting creditors to its terms.

In that sense, therefore, the Bankruptcy Code is arguably more debtor-friendly than other countries' insolvency laws. It is likely for this reason that the US bankruptcy courts see such a high number of commercial Chapter 11 filings. For example, for the past five years (ending 30 June 2019), there were more than 30,000 commercial Chapter 11 filings in the US, with approximately 6,000 filings each year.[1] The year with the most Chapter 11 filings (10,626) was during the US recession in 2010.[2]

Commencement of a bankruptcy case

A Chapter 11 case is commenced upon the filing of a bankruptcy petition with the bankruptcy court (the date on which this occurs is referred to as the petition date) in an appropriate jurisdiction. The Bankruptcy Code requires an entity to have a residence, domicile, place of business or property in the United States to be a debtor. While it is usually the case that the distressed company will file a bankruptcy petition commencing a voluntary bankruptcy proceeding, a company's unsecured creditors may also file a petition placing the company in an involuntary bankruptcy proceeding (assuming certain statutory requirements are met).

Once a company files for Chapter 11, a bankruptcy estate is created. This estate comprises all of the debtor's legal and equitable interests in property as of the petition date, referred to as property of the estate. Assets that are not part of the estate are not under the jurisdiction of the bankruptcy court and are not subject to the protections of the Bankruptcy Code. Chapter 11 gives rise to the legal fiction that the pre-petition company and the post-petition debtor are separate and distinct legal entities.

The petition date also serves to delineate pre-petition and post-petition claims. Post-petition claims or administrative expense claims are generally payable in the ordinary course of business. Unless and until authorised by a bankruptcy court order, the debtor is prohibited from paying any pre-petition debt. At the outset of a bankruptcy case, a debtor will usually file 'first-day' motions which, among other things, include the request for relief to pay certain limited pre-petition claims in order to seamlessly transition the company into bankruptcy. These may include payment of pre-petition amounts owed to employees, customers, insurance, taxes to government authorities and, in some cases, certain vendors deemed to be critical to the uninterrupted operations of the business. Procedural first-day motions may include requests for joint administration of the bankruptcy cases of the debtor and its affiliates that have also filed for bankruptcy, consolidation of creditor lists, and an extension of certain deadlines for filing financial schedules and statements. Other significant first-day motions include requests to maintain a debtor's existing cash-management system and for use of cash collateral and approval of post-petition financing to fund the expenses of administering the bankruptcy case as well as operational costs.

1 See Caseload Statistics Data Tables at https://www.uscourts.gov/statistics-reports/caseload-statistics-data-tables (last visited 23 September 2019).

2 See AACER at https://www.abi.org/newsroom/bankruptcy-statistics (last visited 23 September 2019).

Key players in a bankruptcy case

In addition to the debtor, other significant parties participating in the bankruptcy case include the bankruptcy judge, the Office of the United States Trustee (the US Trustee), and the official committee of unsecured creditors (the Committee). In some cases, a group of parties with similar interests in the debtor will form an unofficial ad hoc committee, such as a group of equity holders or bondholders.

The US Trustee is an agency of the United States Department of Justice that is responsible for overseeing the administration of the bankruptcy case to ensure that the debtor complies with its obligations as debtor in possession, as well as for reviewing professional fees and various pleadings throughout the bankruptcy case to ensure compliance with the Bankruptcy Code and the underlying policies. The US Trustee also appoints the members of the Committee, which generally occurs shortly after the petition date. The membership and size of the Committee is usually reflective of a cross-section of the body of unsecured creditors. If no creditors are interested in serving, there may be no Committee appointed. The Committee is charged with representing and advocating for the interests of all of the unsecured creditors in the bankruptcy case. The fees and expenses incurred by professionals retained by the Committee are borne by the debtor's estate after bankruptcy court approval.

Upon request of a party in interest, in certain circumstances, an examiner may be appointed to conduct an investigation into certain issues in the bankruptcy case, such as the debtor's conduct, the debtor's business, financial affairs or other claims in the bankruptcy, as directed by the bankruptcy court. The examiner is an independent third party, and its fees and expenses are also paid by the debtor's estate.

In certain cases, the bankruptcy court may appoint a Chapter 11 trustee (not to be confused with the US Trustee) for cause. Cause includes fraud, dishonesty, incompetence or gross mismanagement of the debtor's affairs by existing management. If appointed, the Chapter 11 trustee supplants existing management and conducts the debtor's day-to-day operations as appropriate.

Debtor's disclosure obligations

Chapter 11 affords creditors a measure of transparency into a debtor's holdings, ownership and finances. Once a debtor has availed itself of the protections of Chapter 11, it must satisfy various reporting requirements. Early in the case, the debtor must file a corporate ownership statement and an equity ownership statement, as well as its schedules of assets and liabilities (listing every asset and liability as of the petition date based upon its books and records) and statement of financial affairs (including a listing of payments made to third parties within 90 days prior to the petition date, and to its insiders within one year prior to the petition date). The debtor must include in its schedules a listing of all claims against it of which it is aware as of the petition date, and indicate whether each scheduled claim is disputed, contingent or unliquidated.

Moreover, throughout the pendency of the bankruptcy case, the debtor must file monthly operating reports reflecting its business activities for the prior month including cash flow, income, accounts receivable and accounts payable. Failure to comply with financial reporting obligations may result in the bankruptcy court finding cause for the appointment of a trustee to take control of the company and the operation and management of its business or, in rare instances, for dismissal of the case. The debtor must also file periodic financial reports of the value, operations and profitability of each entity that is not a publicly traded corporation or a debtor in Chapter 11 in which the estate holds a substantial or controlling interest.

The debtor, through one or more of its officers, must also participate in a debtor interview conducted by the US Trustee. Also, shortly after the commencement of the Chapter 11 case, the US Trustee convenes and presides over a meeting of creditors.

The automatic stay

Upon the filing of a voluntary bankruptcy petition, the automatic stay immediately goes into effect, without entry of an order, to preclude all creditors from engaging in any collection efforts or taking any action against the debtor or its estate, subject to certain exceptions. Absent a bankruptcy court order, creditors are prohibited from enforcing security interests or taking any other action that would affect or interfere with property of the estate; all pending litigation is stayed, and new lawsuits are not permitted to be filed against the debtor.

However, a creditor may commence post-petition litigation against the debtor if the litigation is brought as an adversary proceeding in the bankruptcy court. The Federal Rules of Bankruptcy Procedure govern adversary proceedings, as well as the main bankruptcy case itself.

If a creditor seeks to commence or continue litigation outside the bankruptcy court or otherwise seeks to seize the debtor's property, it must seek relief from the bankruptcy court to lift the automatic stay. It must demonstrate cause for lifting the stay, such as lack of adequate protection (the value of secured creditors' collateral is being diminished), and in cases where it seeks to seize property, it must show that the debtor does not have equity in the property and that the property is not necessary for an effective reorganisation.

Use of cash collateral and debtor-in-possession financing

It is often the case that under a pre-petition credit facility, the debtor has granted to a lender a security interest in the debtor's cash, bank accounts or receivables. Therefore, to continue to operate its business and fund the expenses of administering the bankruptcy case, the debtor will need to use this cash collateral, which it may do with consent of the secured lender or, absent consent, pursuant to a bankruptcy court order. If a secured lender with an interest in cash collateral objects to the use of the collateral, the bankruptcy court must ensure that the secured creditor receives adequate protection from any diminution in value of its interest in the collateral.

Forms of adequate protection under the Bankruptcy Code include, but are not limited to:

- lump sum or periodic cash payments to the extent that the use will result in a decrease in value of the secured party's interest in the property;
- additional or replacement liens to the extent that the use of the property will cause a decrease in the value of the secured party's interest in the property; and
- such other relief as will result in the realisation by the entity of the indubitable equivalent of the entity's interest in the property.

In some cases, bankruptcy courts have held that an oversecured creditor's equity cushion (where the value of the collateral exceeds the value of the secured claim) is sufficient to constitute adequate protection. Creditors holding unsecured claims are not entitled to adequate protection. Likewise, an undersecured creditor (whose claim exceeds the value of its collateral) is not entitled to adequate protection of its deficiency claim.

In instances where additional liquidity beyond the use of cash collateral is necessary, the debtor will need to obtain debtor-in-possession (DIP) financing. DIP financing is post-petition credit that is usually secured by a priming lien (a lien senior to existing liens held by pre-petition lenders) or liens on other unencumbered assets. A debtor may grant a priming lien as part of the DIP financing if it is unable to obtain unsecured or junior secured debt and the secured creditor either consents or receives adequate protection. In many cases, DIP financing may be provided by an existing lender that does not want a third-party lender to step in and prime its lien.

Significantly, DIP financing claims are entitled to super-priority administrative expense status. Administrative expense claims must be paid under the Chapter 11 plan in order for the debtor to exit Chapter 11 (unless the lender agrees otherwise) and ahead of most other creditors.

Asset sales

One of the key benefits of Chapter 11 is the debtor's ability to sell its assets free and clear of all liens, claims and other encumbrances. The encumbrances would then attach to the sale proceeds. A debtor seeking to sell substantially all of its assets in a 363 sale (pursuant to section 363 of the Bankruptcy Code) will usually seek bankruptcy court approval of a competitive bidding and auction process to obtain the highest or otherwise best offer for its assets and thereby maximise value for all creditors. If the debtor is aware of a serious bidder, it may designate the bidder as the stalking horse, whose bid sets the minimum price for its assets. Competing offers must then be higher or otherwise better than the bid proposed by the stalking horse. One of the benefits of being designated the stalking horse is that, in many cases, it is entitled to reimbursement of expenses (usually a capped amount) and a break-up fee (typically between 1 per cent and 3 per cent of the purchase price) if the debtor ultimately chooses another bidder. These bid protections are intended to compensate the stalking horse for conducting diligence and participation, without which the debtor may not have obtained a higher or better purchase price for its assets. A secured lender with an allowed secured claim seeking to participate as a bidder for the debtor's assets may credit bid the amount of its pre-petition secured debt.

Claims resolution

A claim under the Bankruptcy Code includes a right to payment, regardless of whether the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured. Creditors who have a claim as of the petition date should file a proof of claim identifying the amount and basis for their claim. The deadline to file a proof of claim, generally referred to as the bar date, is established by bankruptcy court order. The debtor and its advisers will then review all filed claims and object to allowance of any claims that are duplicative, misclassified or unsupported by the debtor's books and records, for example. A creditor who agrees with the amount of its scheduled claim generally is not required to file a proof of claim (unless the claim is scheduled as disputed, contingent or unliquidated).

Distribution in Chapter 11 cases is governed by the absolute priority rule, which dictates that claims entitled to first priority must be fully satisfied before debts of a later priority receive any distribution. A secured creditor must receive either the collateral securing its claim or be paid the value of the property. If the debt owed to a secured creditor exceeds the value of the underlying collateral, the remaining portion of its claim (its deficiency claim) is an unsecured claim.

Administrative expense claims must be paid before unsecured priority claims or general unsecured claims. Administrative claims include professional fees, claims for goods and services provided during the post-petition period, and other actual, necessary costs and expenses of preserving the estate. Priority claims include certain pre-petition wages and employee benefits (both of which are subject to a statutory cap, adjusted periodically for inflation) and certain taxes. General unsecured claims have a lower priority, and these claims may not be paid until the higher priority claims are paid in full. Equity interests have the lowest priority and, therefore, will not receive a distribution until general unsecured claims are paid in full and only then if there are any remaining assets.

There are limited exceptions to the absolute priority rule, such as new value, whereby equity holders may receive new equity in the reorganised debtor (even if unsecured creditors are not paid in full on their claims) if they provide value or invest new capital in the reorganised company.

Treatment of executory contracts and leases

A Chapter 11 debtor has the critical right to assume (decide to continue performing), reject (stop performing) or assume and assign (frequently, to a buyer of assets) unexpired leases and executory contracts. An executory contract is a contract where there are material unperformed obligations of both parties as of the petition date, non-performance of which would result in material breach, excusing the other party's performance. This allows the debtor to reject burdensome agreements and assume those that are favourable or necessary for its fresh start. However, if a debtor decides to assume or reject a contract or lease, it must be assumed or rejected as a whole with all of its benefits and burdens. The debtor may not cherry pick selected beneficial provisions within a particular contract or lease to assume or reject.

With the exception of unexpired real property leases, the debtor has until confirmation of a Chapter 11 plan to assume or reject executory contracts, though contract counterparties may seek judicial intervention to compel the debtor to assume or reject a contract prior to plan confirmation. The debtor has 120 days following the petition date to assume or reject unexpired real property leases (which, if requested, may be extended for a period of 90 days). However, if the lease is not assumed prior to this deadline, it is automatically rejected.

During the interim period from the petition date to the date on which the debtor decides to assume or reject an executory contract or unexpired lease, the counterparty is required to continue to perform its obligations under the agreement (despite any pre-petition breach of the agreement by the debtor), and the debtor is obligated to pay for these services in the ordinary course of business as an administrative expense.

If the debtor decides to reject a contract or lease, this rejection constitutes a breach of the contract as of the petition date whereby the counterparty is entitled to file a claim for damages arising from the breach (referred to as rejection damages), which is treated as a general unsecured claim. The counterparty's proof of claim for rejection damages will be administered as part of the claims resolution process. If the debtor rejects a real property lease, the landlord's rejection damages claim is statutorily capped. If a debtor assumes an executory contract or unexpired lease and, later in the bankruptcy, decides to reject the agreement, any damages resulting from the rejection are afforded administrative expense status.

With the exception of personal service contracts, contracts to make a loan or extend other debt financing or financial accommodations and certain intellectual property licences, a debtor generally may assign a contract or lease to third parties despite any anti-assignment provisions in the contract or lease. Prior to assuming an executory contract or unexpired lease, the debtor must cure any monetary default.

Contract or lease provisions that provide for the termination of the agreement upon a bankruptcy filing – ipso facto clauses – are unenforceable under the Bankruptcy Code (with limited exceptions) and, therefore, a debtor may still assume the agreement notwithstanding this provision.

Avoidance actions

Another aspect of administering a bankruptcy estate is the recovery through avoidance actions of assets and property transferred pre-petition in order to increase assets available to be distributed to creditors. Avoidance actions include actual or constructive fraudulent transfers (under both state law and Bankruptcy Code), preferences (transfers made within 90 days prior to the petition date to third parties on account of antecedent debts or within one year prior to the petition date to insiders on account of antecedent debts) and improper set-offs.

Chapter 11 plan process

A Chapter 11 case culminates in confirmation of a debtor's plan of reorganisation or plan of liquidation. A Chapter 11 plan is accompanied by a disclosure statement, which is akin to an offering memorandum outside of bankruptcy. Before a disclosure statement can be mailed to creditors, it must be approved by the bankruptcy court as providing adequate information for a creditor to make an informed judgement on whether to vote to accept or reject the proposed plan.

Claims and interests are grouped into classes by type such that any given class contains similarly situated creditors for treatment and distribution under the plan. For a Chapter 11 plan to be approved by the bankruptcy court, each class must vote in favour by a majority in number and two-thirds in amount of allowed claims of such class held by creditors who vote. A class of creditors or interest holders not receiving any distribution under the plan is deemed to reject the plan, and a class of creditors or interest holders whose legal rights are unimpaired (not altered) is deemed to accept the plan. Under certain circumstances, if at least one class votes to accept the plan, it may be confirmed over the objection of the other classes, which is generally referred to as cramdown. For a Chapter 11 plan to be crammed down, the bankruptcy court must find that, among other things, the plan is fair and equitable to all non-accepting creditors and interest holders, and that it does not unfairly discriminate against dissenting classes.

The fair and equitable test is different depending on the type of claims or equity interests. A plan is fair and equitable with respect to a non-accepting class of secured claims if it provides that each secured creditor in the class will:

- retain its respective security interest to the extent of the allowed amount of its secured claim, such that it receives deferred cash payments with a present value at least equal to the secured claim;
- receive the proceeds of the sale of its collateral in the allowed amount of its secured claim; or
- receive the indubitable equivalent of its claim, such as abandoning the collateral to the secured creditor or providing a lien on substantially similar collateral.

A plan is fair and equitable with respect to a non-accepting class of unsecured claims if it provides that:

- each holder of an unsecured claim will receive or retain, on account of its respective claim, property (including cash) of a value equal to the allowed amount of its claim; or
- no junior class of creditors or equity interests will receive payment or retain an equity ownership under the plan.

A plan is fair and equitable with respect to a non-accepting class of equity interests if:

- the plan provides that each holder of an equity interest in that class receives or retains under the plan on account of its equity interest property of a value, as of the effective date of the plan, equal to the greater of:
  - the allowed amount of any fixed liquidation preference to which the holder is entitled;
  - any fixed redemption price to which the holder is entitled; or
  - the value of the interest; or
- if the class does not receive the amount, no class of equity interests junior to the non-accepting class will receive or retain any property under the plan.

In addition to fair and equitable treatment, the plan must not unfairly discriminate between or among classes of claims or equity interests that are of equal priority and receiving different treatment. This test does not require treatment to be the same, just fair. Bankruptcy courts may take into account a number of factors in determining whether a plan discriminates unfairly, such as whether the discrimination has a reasonable basis and is proposed in good faith, whether the debtor can confirm the plan without the discrimination, and whether the degree of discrimination is proportionate to its rationale.

Types of Chapter 11 cases

There are generally four types of Chapter 11 cases.

Pre-packaged

In a pre-packaged bankruptcy case, the company negotiates the terms of a plan of reorganisation and solicits votes from creditors before the petition date and, in doing so, expedites the Chapter 11 process. The bankruptcy petition is filed along with the creditor-approved plan of reorganisation and disclosure statement. The bankruptcy case implements the accepted plan. Pre-packaged cases generally occur in situations in which only financial claims are being compromised (and, therefore, are entitled to vote), and other claims, such as trade creditors, are unimpaired. Pre-packaged Chapter 11 cases can be very speedy once filed, but there are often lengthy negotiations prior to filing. Much of the work necessary for a Chapter 11 pre-packaged plan can be done in parallel with the company's efforts to effectuate a successful out-of-court restructuring, such as an exchange offer. Entering Chapter 11 with a creditor-approved plan affords more certainty of outcome and allows the company to better control its messaging to key parties about the restructuring and the company's future business strategy.

Pre-negotiated

In a pre-negotiated (or pre-arranged) bankruptcy, the company has obtained the support of its major constituent creditors in the form of a term sheet or restructuring support agreement, but does not solicit votes on a plan until after the petition date. A pre-negotiated bankruptcy can vary widely in the degree of negotiation and the pre-filing commitment from various constituents.

Freefall

In a freefall situation, a company enters Chapter 11 without any formal agreement with its key constituents on a strategic plan for restructuring or emergence from bankruptcy. A freefall bankruptcy may be unsettling to a debtor's trade creditors and employees, for example, because there is less certainty regarding the outcome, but the company is able to take advantage of the various benefits and protections afforded by Chapter 11, such as the ability to reject burdensome contracts, obtain financing, or sell assets free and clear of existing liens and claims, for example.

Liquidation

In a liquidating Chapter 11 case, the company conducts an orderly wind-down of its business and sale of its assets. While a company may file a Chapter 7 petition for liquidation with the appointment of a Chapter 7 trustee to run the process, Chapter 11 liquidation permits management and employees familiar with the business to maintain control of the wind-down process and thereby maximise the value of the assets for the benefit of the creditors.

Cross-border issues

The Bankruptcy Code permits a foreign debtor with an insolvency proceeding pending outside the United States to bring an ancillary proceeding under Chapter 15 of the Bankruptcy Code for the purpose of receiving assistance from the US bankruptcy court. Chapter 15 was enacted in 2005 after the US adopted the UN Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law. Since its inception, Chapter 15 filings have been increasing, reflecting the increasingly global economy, from five filings in 2005 to 139 for the 12-month period ending 30 June 2019.[3] While a more fulsome discussion of Chapter 15 is outside the scope of this chapter, it is important to highlight the differences between Chapter 11 and Chapter 15 for a foreign debtor seeking to commence a bankruptcy case in the United States.

Chapter 15 is an ancillary proceeding that enables a foreign representative of the debtor to seek recognition in the United States of a pending foreign insolvency proceeding. By contrast, a debtor or its creditors may seek Chapter 11 relief, which is a plenary proceeding. Thus, broader relief is available to a Chapter 11 debtor than a Chapter 15 debtor.

For instance, in Chapter 15, the automatic stay and any relief granted by the bankruptcy court apply only with respect to the debtor's property within the territorial limits of the United States; Chapter 11 is intended to provide extraterritorial relief as to a debtor's assets wherever located. (In both cases, however, the bankruptcy court is constrained by the limits of personal jurisdiction. In addition, the extraterritorial effect of a US court order will depend on the jurisdiction in which it is sought to be enforced.) While a Chapter 11 debtor has access to the full range of avoidance powers, a foreign representative in a Chapter 15 case may not bring preference or fraudulent conveyance claims under the US Bankruptcy Code, only under non-bankruptcy law.

3 See AACER at https://www.abi.org/newsroom/bankruptcy-statistics (last visited 23 September 2019); https://www.uscourts.gov/sites/default/files/data_tables/bf_f5a_0630.2019.pdf (last visited 23 September 2019).

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US: Dynamic Trends in Chapter 15

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In summary

This chapter discusses several recent major decisions by US bankruptcy courts in cases brought under Chapter 15 of the US Bankruptcy Code and explores a number of trends that have emerged.

Discussion points

- Chapter 15 jurisprudence not governed by bright-line, per se rules and context of the restructuring can be highly relevant
- General trend in Chapter 15 decisions of US courts' flexibility in giving effect to foreign insolvency proceedings
- Chapter 15 jurisprudence dynamic and still evolving

Referenced in this article

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- *In re Barnet*, 737 F.3d 238 (2d Cir. 2013)
- *In re Vitro S.A.B. de C.V.*, 701 F.3d 1031, 1042 (5th Cir. 2012)
- *In re Oi S.A.*, 587 B.R. 253 (Bankr. S.D.N.Y. 2018)
- *In re Agrokor d.d.*, 591 B.R. 163 (Bankr. S.D.N.Y. 2018)
- *In re Servicos de Petroleo Constellation S.A.*, Case No. 18-13952, ECF No. 123, (Bankr. S.D.N.Y August 1, 2019)
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Introduction

The primary principles underlying the enactment in 2005 of Chapter 15 of the US Bankruptcy Code were the globalisation of commerce and cross-border cooperation. Through its passage, the US Congress sought to effectuate the mandate of the UNCITRAL Model Law on Cross-Border Insolvency (UNCITRAL Model Law), with its stated purpose to 'provide effective mechanisms for dealing with cases of cross-border insolvency'.[1] In furtherance of this goal, Chapter 15's comprehensive legislative framework enables a US court to recognise a foreign judicial or administrative insolvency proceeding, thereby providing foreign debtors access to US courts to administer assets, resolve claims and take certain other actions (eg, impose stay over pending litigation or collection) within the United States.

Chapter 15 case law is still in the early stages of development and US courts continue to grapple with just how far to extend the principles of comity and cooperation while staying true to the policies and principles embedded in US domestic restructurings under Chapter 11 of the US Bankruptcy Code. Through that process, a number of trends have emerged in recent US decisions on recognition and enforcement of foreign insolvency proceedings, which largely demonstrate US courts' flexibility in giving effect to foreign insolvency proceedings, rather than a distrust or rejection of such foreign processes and systems.

Initially following the passage of Chapter 15, a number of bankruptcy court decisions, such as the Second Circuit's decision in *In re Barnet*,[2] (imposing section 109 debtor eligibility requirements in the United States to Chapter 15 foreign debtors) and the Fifth Circuit's decision in *In re Vitro SAB de CV*,[3] (refusing to grant third-party releases approved by Mexican court), appeared to limit the scope and access of Chapter 15. However, recent cases have generally taken a more permissive approach, although this trend is not linear. While most decisions have increased emphasis on providing broad relief to Chapter 15 debtors and have moved the jurisprudence away from formalistic procedural delays, US courts have not adopted per se rules for Chapter 15 recognition and enforcement, which means jurisprudence in this exciting and dynamic area remains highly unsettled.

This chapter discusses several major decisions in the past two years, exploring issues relating to the enforcement of a plan of reorganisation in the United States pending resolution of appeals, determining a foreign debtor's centre of main interests, juggling the appropriate scope of relief in Chapter 15 proceedings and establishing appropriate gating requirements for accessing Chapter 15.

1 See 11 U.S.C. § 1501.

2 737 F.3d 238 (2d Cir. 2013).

3 701 F.3d 1031, 1042 (5th Cir. 2012).

Waiting on the world to change: enforcement of foreign-approved plans in the United States pending resolution of foreign appeals

Once a debtor has obtained approval of its restructuring plan through its foreign proceeding, it is not uncommon for that approval to be appealed in whole or in part in foreign courts and for the debtor to nevertheless push forward with seeking enforcement of the plan in the United States. This context implicates the thorny problem of whether the Chapter 15 court should delay enforcement in the United States pending an ongoing foreign appeal. While two cases from 2018 favoured the speedy enforcement of a foreign-approved restructuring in spite of pending foreign appeals as long as the foreign lower court decision's was not stayed pending appeal, a more recent opinion in 2019 appears to buck that trend, favouring a wait-and-see approach that may hinder closing of restructuring transactions. This pattern suggests that courts will perform a fact-specific inquiry on the question and so counsel to a Chapter 15 debtor seeking enforcement of its plan over a foreign appeal should accordingly be sure to develop a record to support that relief.

In both cases where the Chapter 15 court enforced the foreign restructuring plan over the pending foreign appeals, the court emphasised the importance of comity in avoiding the delay of the debtor's restructuring. In *In re Oi SA*,[4] a foreign debtor's restructuring plan was overwhelmingly confirmed by a court in Brazil. A group of shareholders appealed the plan confirmation in Brazil without successfully obtaining a stay pending appeal, with the appeal still pending when Judge Lane was asked to enforce the Brazilian plan in the United States. In deciding to enforce the Brazilian plan despite the appeal, Judge Lane emphasised his broad discretionary authority, including the authority to grant relief consistent with principles of comity. The court reasoned that unstayed foreign appeals should not prevent enforcement of a confirmed restructuring plan because doing so would 'provide the very same stay pending appeal that . . . [was] denied by the Brazilian courts'.[5]

Similarly, in *In re Agrokor DD*,[6] Judge Glenn refused to delay enforcement of the restructuring and settlement agreement approved by a Croatian insolvency court despite a potential pending dispute in the UK that may alter the enforcement of the plan with respect to English law-governed debt. Like Judge Lane in *Oi*, Judge Glenn found that the purposes of Chapter 15 required prioritising the debtor's ability to effectuate its restructuring plan in a fair and efficient way without requiring incessant analysis of potential foreign appeals. In that case, Agrokor DD, a holding company of food-related companies, reached a settlement agreement with creditors holding 78 per cent of claims. Judge Glenn agreed to enforce the terms of the settlement agreement (with the caveat that he will not enter an order until the settlement agreement becomes effective in Croatia), even though there was a possibility for an English court to modify the settlement agreement. Although the English court had also recognised the proceeding in Croatia, creditors there had argued that the English court should decline to enforce the settlement agreement under an English common law rule known as

4 587 B.R. 253 (Bankr. S.D.N.Y. 2018).

5 Id. at 270.

6 591 B.R. 163 (Bankr. S.D.N.Y. 2018).

the *Gibbs* Rule, which provides that rights under English-law governed debt can only be adjudicated by English laws and cannot be discharged in a foreign proceeding. Judge Glenn dismissed that concern, reasoning that a 'broader analysis of comity with respect to every nation involved' is not required 'because the Court's decision to recognize and enforce the Settlement Agreement is effective within the territorial jurisdiction of the United States'.[7] To make the point clearer, Judge Glenn further offered a critique of the *Gibbs* Rule and its territorialism as incongruent with the UNCITRAL Model Law's goal for bankruptcy proceedings that are 'unitary and universal, recognised internationally and effective in respect of all the bankrupt's assets'.[8] The *Agrokor* decision was rendered in the context of no creditor opposition to recognition and enforcement of the Croatian plan, which may also have been a factor in Judge Glenn's decision.

While these cases appeared to demonstrate a trend of Chapter 15 courts avoiding imposing a delay in enforcement of an unstayed foreign court-approved plan, a more recent decision from 2019 shows that courts will not uniformly enforce unstayed foreign plans. In *In re Servicos de Petroleo Constellation SA* (*QGOG*),[9] Judge Glenn took a decidedly different approach to resolving this question than he took in Agrokor. There, Judge Glenn stayed the motion to enforce a confirmed plan in Brazil pending a decision from the Brazilian Court of Appeals. Crucially, just like in *Oi*, no stay on the effectiveness of the plan was granted in Brazil. But Judge Glenn noted in his decision in *QGOG* that he considered issues raised by a dissenting creditor regarding due process and voting issues to be 'serious' enough not to rush recognition of the foreign plan until at least the first level of court of appeals in Brazil had a chance to review the issues. Judge Glenn reasoned that there was no purpose in enforcing the confirmed plan in the United States if it will be substantively reversed on appeal. While noting that foreign court-approved plan can be enforced in the exercise of comity, Judge Glenn explained that the interests of creditors, which must also be sufficiently protected, must take precedence even if the result is delay in enforcement of the restructuring.

Interestingly, notwithstanding the apparent inconsistency between *QGOG* and *Oi*, Judge Glenn underscored his view that his decision was consistent with his prior opinion from *Agrokor*, where he had declined to enforce the settlement agreement until it became effective in the foreign jurisdiction. However, the two cases may have had important differences in terms of their practical effects. *Agrokor* involved a small delay on enforcement until the settlement agreement became effective abroad, resulting in a reasonable approach given that the United States should not accelerate enforcement over a foreign tribunal. On the other hand, the delay in *QGOG* is more significant and could potentially extend a Brazilian appellate court reviews the confirmed plan on a timeline that is, itself, somewhat uncertain. Moreover, the decision in *QGOG* effectively granted a stay pending appeal when no such stay was granted in the foreign court, in direct contradiction of the holding in *Oi*.

7 591 B.R. at 186-87.

8 Id. at 192.

9 Case No. 18-13952, ECF No. 123 (Bankr. S.D.N.Y 1 August 2019).

Those who were hoping that *Oi* established a bright-line rule that foreign appeals absent a stay will not delay US enforcement will be sorely disappointed by the *QGOG* decision. Indeed, *QGOG* will give renewed steam to dissident creditors who wish to arbitrage between different bankruptcy systems and hold up enforcement of a plan by invoking due process concerns. Still, there are important factual differences that may have motivated Judge Glenn's opinion in *QGOG*. For instance, Judge Glenn noted that the Brazilian proceedings had previously been reversed by appellate decisions and that unlike in *Agrokor*, where no objections to recognition of the foreign plan were raised, several objections were raised before the US court in *QGOG*. Practitioners navigating this issue should be aware that the jurisprudence remains highly unsettled without bright-line rules and factual nuances may be dispositive in a court's ultimate decision on whether to delay enforcement in the United States based on foreign appeals.

Where did you go? Determining a debtor's centre of main interests

At the start of a Chapter 15 case, the first question a US court must answer is whether the foreign proceeding is a 'main proceeding' – a case pending in the country where the debtor's centre of main interests (COMI) is located – or a 'non-main proceeding' – a case pending in the country where the debtor has only an 'establishment'.[10] The determination is important because a foreign main proceeding entitles the foreign debtor to broader automatic relief, including imposition of the automatic stay in the United States, whereas such relief is discretionary for a non-main proceeding. COMI is not defined in the statute, but there is a statutory presumption that the debtor's COMI lies in the jurisdiction of its registered office. Still, creditors may challenge the location of a debtor's COMI (and thus whether the proceeding is a main proceeding) in order to disrupt or otherwise limit the reach of the Chapter 15 case.

Recent cases suggest that courts are willing to adopt a flexible approach to determining a debtor's COMI, in some cases ratifying a debtor's COMI shifting shortly before a Chapter 15 filing and even granting discretionary automatic stay relief to non-main proceedings. However, this approach is not without exceptions – courts are often vigilant of bad faith on the part of either the debtor or a creditor seeking recognition and may restrict the scope of relief accordingly to address inequities.

Let it be: flexible approach to determining COMI

Two recent decisions by Judge Glenn in the Southern District of New York show a willingness to bend the traditional concept of COMI in order to provide the debtor with Chapter 15 relief necessary to its reorganisation. In *In re Ocean Rig UDW Inc*,[11] Judge Glenn considered whether the actions of a foreign debtor to shift its COMI to the Cayman Islands, a location with favourable insolvency laws, less than a year before commencing insolvency proceedings, constituted legitimate 'COMI migration' or bad faith 'COMI manipulation'. The Second Circuit previously held that a court may find a debtor manipulated its COMI in bad faith to disregard

10 See 11 U.S.C. § 1502.

11 570 B.R. 687 (Bankr. S.D.N.Y. 2017).

a change in where the debtor's COMI is located.[12] In *Ocean Rig*, Judge Glenn found that the debtors had legitimately migrated their COMI because the debtors had taken concrete steps for the 'proper purpose' of facilitating a 'value maximizing restructuring'.[13] The court found no evidence of 'insider exploitation, untoward manipulation, [or] overt thwarting of third-party expectations' indicating bad faith.[14]

In the *QGOG* case, Judge Glenn could not find that the COMI of a Luxembourg parent of a group of debtors was in Brazil (where the other debtors' COMIs are located), but still granted discretionary automatic stay relief for the resulting foreign non-main proceeding.[15] *QGOG* was a complex restructuring involving multiple Chapter 15 debtors, which required the court to determine the COMI for each debtor. Judge Glenn found that the location of the ultimate parent holding company's COMI was Luxembourg, but that the debtor-parent had sufficient ties to Brazil for recognition of Brazilian proceeding as foreign non-main proceeding. For the other debtors, Judge Glenn recognised the Brazilian proceeding as the respective foreign main proceeding. Even so, Judge Glenn granted discretionary automatic stay relief for the non-main recognition of the Luxembourg parent, noting that the foreign main proceeding is entitled to 'nearly identical relief as the relief afforded to the Chapter 15 Debtors whose COMI was determined to be in Brazil'.[16]

QGOG illustrates that even where COMI analysis did not result in foreign main recognition, the court may still grant broad discretionary relief to ensure uniform treatment for the debtors and reduce the likelihood of procedural headaches that may compromise the restructuring.

Be a good boy: evaluating bad faith

Nevertheless, this recent trend of flexibility to COMI analysis is not without exceptions. Frequently, courts have refused to give a blank cheque in COMI analysis and will still scrutinise whether the party seeking recognition acted in bad faith. In *In re Oi SA*,[17] discussed above, Judge Lane addressed COMI issues in the context of two competing foreign restructuring proceedings of a Dutch subsidiary of a Brazilian conglomerate, one in Brazil (the Brazilian Proceeding) and one subsequently commenced by a creditor in the Netherlands (the Dutch Proceeding). Judge Lane maintained his finding that the debtor's COMI was in Brazil, in part because of an objecting creditor's role in initiating the Dutch Proceeding without opposing Chapter 15 relief for the Brazilian proceeding. In that case, Judge Lane previously recognised Oi's Brazilian Proceeding as the foreign main proceeding for Oi Brasil Holdings Coöperatief UA (Coop), a Dutch subsidiary, because Coop had limited operations and primarily acted as a tax-advantaged financial vehicle for Oi. Certain of Coop's creditors, unsatisfied with the

12 See *In re Fairfield Sentry*, 714 F.3d 127, 138 (2d Cir. 2013).

13 570 B.R. at 703.

14 Id. at 707.

15 600 B.R. 237 (Bankr S.D.N.Y. 2019).

16 Id. at 294.

17 578 B.R. 169 (Bankr. S.D.N.Y. 2017).

recognition, commenced legal proceedings against Coop in the Netherlands, which culminated in the competing Dutch Proceeding. The Dutch insolvency trustee then asked Judge Lane to instead recognise the Dutch Proceeding as Coop's foreign main proceeding.

In a lengthy opinion following trial, Judge Lane denied the petition, finding no basis for the relief sought because the court had been fully aware of Coop's connections to the Netherlands at the time of recognition of the Brazilian Proceeding. Interestingly, Judge Lane expressly considered an objecting creditor's role in commencing the Dutch Proceeding as part of its strategy to block recognition of any Brazilian restructuring plan in order to increase its leverage. Judge Lane found that the objecting creditor's actions were 'at odds with many of the goals of Chapter 15', including fair and efficient administration of international insolvencies, and criticised the objecting creditor for 'weapon[ising] Chapter 15 to collaterally attack' the Brazilian Proceeding.[18]

In a separate case before him, *In re BSG Resources Limited*,[19] Judge Lane expressed interest in exploring whether a foreign representative filed for Chapter 15 in 'bad faith' to avoid an adverse judgment. In this case, *Vale*, the beneficiary of an arbitral award against the debtor and the debtor's largest creditor, opposed recognition of the foreign proceeding. At a protective order hearing, Judge Lane suggested that it may be theoretically possible to limit the scope of recognition relief granted to a foreign representative who filed in bad faith, but left the issue to be determined at a later date. Judge Lane noted, albeit cryptically, that there is a 'difference of opinion about legally the relevance' of bad faith in determining the scope of recognition relief.[20] However, Judge Lane allowed broad discovery on whether the Chapter 15 petition was brought in bad faith, including:

- whether the Chapter 15 proceeding was brought in an effort to avoid compliance with an adverse judgement;
- whether there were improper attempts at controlling a foreign representative; and
- whether the debtor manipulated its COMI in bad faith.

Because there is limited case law on whether a bad faith filing (absent bad faith COMI manipulation) could justify denying recognition, this case is a worthwhile one to follow.

Because a foreign debtor's COMI is one of the first questions analysed by a US bankruptcy court in a Chapter 15 proceeding, debtors and creditors alike should be cognisant that, while some judges may favour a flexible approach to COMI, facts suggesting bad faith manipulation on the part of the party seeking recognition could easily derail the efforts seeking recognition.

Do you want fries with that? Scope of relief under Chapter 15

Recognition is only the beginning of the Chapter 15 process. Following recognition, a US bankruptcy court has discretion to grant 'appropriate relief' under section 1521 or provide 'additional assistance' pursuant to section 1507. The question of the scope of appropriate relief

18 Id. at 242.

19 Case No. 19-11845 (Bankr. S.D.N.Y. 2019).

20 Hr'g Tr. 56:22, *In re BSG Resources Limited*, Case No. 19-11845 (Bankr. S.D.N.Y. July 29, 2019).

often tests the usefulness of comity as a guiding principle. Two recent cases demonstrate that while courts may prioritise comity to grant broad relief under Chapter 15 to implement a foreign court-approved restructuring, there are also limits to comity as a guiding principle. US courts, even when trying to facilitate the enforcement of a foreign plan, are nevertheless constrained by bedrock principles of US law, both bankruptcy and otherwise. Those seeking to predict the scope of relief granted by a US bankruptcy court would be wise to keep in mind these two competing considerations.

No party in the USA: enforcement of choice of law provisions

Throughout the relatively short existence of Chapter 15, the concept of comity to foreign tribunals has been at its heart. Often, the principle of comity has led US courts to limit their involvement (or, as some might call it, interference), in the processes of the foreign proceeding. This trend can be seen in a recent case, in which a Delaware bankruptcy court compelled a creditor to resolve the priority of its claims through a foreign proceeding, even when a choice of law clause pointed to the United States.

In *In re Energy Coal SPA*,[21] an Italian debtor entered into a contract with certain US contractors, which contained a Florida choice of law provision for any dispute. The Italian restructuring was later recognised in the United States as a foreign main proceeding. The US contractors objected to the enforcement of the Italian-court approved plan in the United States, arguing that the plan improperly resolved the priority status of their claims because their contracts required adjudication of all disputes by a Florida court. Judge Silverstein sided with the foreign representative, holding that the validity and amount of the claims could be determined by a Florida court, but any dispute over priority and distribution must be resolved in Italy. In reaching that decision, Judge Silverstein emphasised that enforcement of the restructuring is guided by considerations of comity and the contractors had provided no basis for the choice of law provisions to 'override the comity afforded foreign main proceedings'.[22] Judge Silverstein implicitly recognised that an adjudication of the priority of a claim in the United States would undermine the legitimacy of the foreign proceeding and create potentially duelling priority schemes, a result that she characterised as neither 'appropriate or sensible'.[23]

The view of comity taken by the court in *Energy Coal* is consistent with a modern, uniform view of cross-border insolvencies, showing US courts are willing cede the power of US laws to ensure uniform results across jurisdictions.

21 582 B.R. 619 (Bankr. D. Del. 2018).

22 Id. at 628–29.

23 Id. at 629.

My house my rules: the limits of comity

Other decisions nonetheless make clear that there are limits to comity as a guiding principle. Take, for instance, *In re Platinum Partners Value Arbitrage Fund LP*,[24] where Judge Chapman had to determine whether to allow discovery in the United States that may be impermissible under foreign law. In *Platinum*, the debtor was a Cayman Islands limited partnership that was placed into liquidation in the Cayman Islands, which proceeding was later recognised as a foreign main proceeding. The Cayman liquidators were tasked with investigating the business of the debtor and sought to get discovery in the United States from an auditor who previously provided audit services to the debtor. The auditor opposed the discovery, arguing that much of its documents are not discoverable under Cayman law.

The *Platinum* case poses a conundrum. Does comity mean that a US court cannot grant discovery relief that would be impermissible in the foreign proceeding? Judge Chapman resolved this problem by first noting that the auditor failed to establish the documents are not discoverable under Cayman law. More interestingly, the opinion explained that, even if the documents were not discoverable under Cayman law, 'comity does not require that the relief available in the United States be identical to the relief sought in the foreign bankruptcy proceeding.'[25] Instead, Judge Chapman looked to the policy underpinnings of Cayman law and concluded that they are not hostile to discovery sought under US laws and, accordingly, 'principles of comity decisively weigh in favo[u]r of granting' discovery.[26]

Platinum demonstrates that while the principle of comity suggests that relief granted in the United States should not offend foreign laws, it does not require identical relief as the foreign court would grant. Indeed, Judge Chapman refused to adopt a reading of comity that would reduce the US court's role to that of 'an avatar for the foreign court' and wished to avoid the prospect of having to 'engage in a full-blown analysis of foreign law each and every time a foreign representative seeks additional relief'.[27]

While the case only deals with discovery, Platinum's reasoning has potentially broad implications, showing that US courts may invoke comity to justify relief that may not otherwise be allowed in the foreign proceeding. Those who are seeking additional relief from US courts under Chapter 15 should keep in mind these two competing considerations: comity favouring relief in line with what is granted by foreign tribunals and refusing to abdicate the role of a US court in deciding appropriate relief in its jurisdiction.

Getting in the door: gating requirements for Chapter 15 relief

While US courts have lowered barriers to debtors seeking Chapter 15 relief in the US, there remain some filters and the protections of Chapter 15 are not available for all foreign debtors. While cases decided shortly after the enactment of Chapter 15 created concerns that the bar for accessing Chapter 15 may have been set improperly high, more recent cases suggest

24 583 B.R. 803 (Bankr. S.D.N.Y. 2018).
25 Id. at 815.
26 Id. at 816.
27 Id. at 816.

that US courts have generally tried to lower the gating requirements for Chapter 15 relief, specifically, these cases have allowed foreign representatives to easily satisfy the 'property' requirement under section 109(a) and have adopted a narrow public policy exception, so as not to overly scrutinise the foreign proceeding.

It does not take much: property requirements under section 109(a)

The Second Circuit's *Barnet* opinion in 2013 required a foreign representative to satisfy the requirements for having a domicile, place of business or property in the United States pursuant to section 109(a).[28] The opinion was initially met with concerns that US courts would severely curtail the availability of Chapter 15 relief by imposing onerous property requirements for foreign debtors. Recent cases show the exact opposite – courts have set the bar so low for a foreign Chapter 15 debtor to satisfy section 109(a) that it is barely a limitation at all.

For example, in *In re BCI Finances Pty Ltd*,[29] Judge Lane held that a US$1,250 retainer placed in the trust account of the foreign liquidator's US counsel satisfied the section 109(a) eligibility requirement. Judge Lane relied on prior Chapter 11 decisions holding that the 'property' requirement is satisfied by 'even a minimal amount of property located in the United States'.[30] Separately, Judge Lane also held that breach of fiduciary claims against former directors that resided in the United States independently satisfied section 109(a).

The low standard for satisfying section 109(a) means that even foreign debtors with no concrete property and only litigation claims against parties in the United States can easily seek the protection of Chapter 15.

Lowering the bar: limited inquiries into foreign proceeding

In another recent case showing that courts have tended to lower the gating requirements for Chapter 15, Judge Lane denied objecting creditors' summary judgment motion arguing that:

- a foreign debtor failed to satisfy the property requirement;
- the foreign representative was not properly appointed; and
- the debtor's Indonesian restructuring proceeding (the Indonesian Proceeding) was manifestly contrary to US public policy.[31]

On the question of whether the debtor has property in the United States, Judge Lane echoed his reasoning in *BCI Finance*, noting that property can encompass a variety of 'intangible assets' and in this case, the debtor was an obligor on an indenture governed by New York law, which constitutes property in the United States.[32]

28 737 F.3d 238 (2d Cir. 2013).
29 583 B.R. 288 (Bankr. S.D.N.Y. 2018).
30 Id. at 293–94.
31 *In re PT Bakrie Telecom Tbk*, 601 B.R. 707 (Bankr. S.D.N.Y. 2019).
32 Id. at 715.

The dissenting creditors also argued that a director of the debtor was not properly appointed as the foreign representative because his appointment by the debtor's board did not occur until three years after the conclusion of the Indonesian Proceeding and thus did not occur 'in' the foreign proceeding pursuant to section 1515(a). Here too, Judge Lane emphasised that the threshold 'is not an onerous one' and must be 'read broadly in order to facilitate the purposes of Chapter 15'.[33] Section 1515(a), which allows a foreign representative 'authorised in a foreign proceeding' to file a Chapter 15 application, should be read broadly to include foreign representatives appointed after the foreign proceeding has been closed.

Finally, Judge Lane also rejected the creditors' motion for summary judgment on the grounds that the Indonesian Proceeding was manifestly contrary to US public policy. Judge Lane started with the proposition that section 1506 of the Bankruptcy Code, which provides that a court may refuse to take action under Chapter 15 if such action would be 'manifestly contrary to the public policy of the United States' must be 'read narrowly'.[34] Holding that summary judgment was not appropriate, Judge Lane pointed to lingering questions of fact regarding whether the administrator and judge in the Indonesian Proceeding were independent and emphasised that there are procedural safeguards in the Indonesian Proceeding that the creditors failed to acknowledge. The opinion cited another recent case from New Jersey, *In re Manley Toys*,[35] where the court held that the actions of Hong Kong liquidators did not violate US public policy, even if those liquidators allegedly took directions from insiders of the debtor, because the creditors had ample notice and remedies in the Hong Kong proceeding.

Both the *BCI* and *PT Bakrie* opinions stand in contrast to *Barnet*. Alleviating concerns that US courts would establish prohibitive and onerous requirements for seeking Chapter 15 protection, these recent cases are consistent with a recent trend of increasing the availability of Chapter 15 for foreign debtors, and will likely be commensurate with an increase in Chapter 15 filings in the United States, particularly in the Southern District of New York.

Conclusion

Conflicting trends in recent decisions make it challenging for practitioners or commentators to identify a single direction either for or against the comity afforded to foreign insolvency proceedings under Chapter 15. While some of these holdings are patently in conflict, most can be reconciled by looking to the context for the restructuring and creditors' opposition.

33 Id. at 717.

34 Id. at 714.

35 580 B.R. 632 (Bankr. D.N.J. 2018).

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The High Burden to Satisfy Standard of Chapter 15

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In summary

This chapter describes the exceptionally high burden parties must overcome to prove that requested relief in a Chapter 15 case is manifestly contrary to US public policy.

Discussion points

- Background on the public policy exception of section 1506 of the Bankruptcy Code
- Successful application of the public policy exception in the context of recognition of a proceeding under Chapter 15 of the Bankruptcy Code
- Successful application of the public policy exception in the context of requests for specific Chapter 15 relief subsequent to recognition
- Case study of the recognition proceedings of *In re Takata Corp*

Referenced in this article

- Chapter 15 of title 11 the United States Code
- Model Law on Cross-Border Insolvency
- *In re Toft*
- *In re Gold & Honey, Ltd*
- *In re Vitro SAB de CV*
- *In re Qimonda AG Bankr. Litig*
- *In re Takata Corp*

Introduction

Chapter 15 of Title 11 the United States Bankruptcy Code (the Bankruptcy Code) enables a representative of a company in an insolvency proceeding outside the United States to obtain recognition of the foreign proceeding and certain other relief from a US bankruptcy court with respect to the debtor's assets and creditors in the United States. Chapter 15 is intended to give a great deal of comity to foreign courts and foreign proceedings, but, as this chapter discusses, comity has a limit. The limit is embodied in section 1506 of the Bankruptcy Code, which permits a US bankruptcy court to refuse to take an action governed by Chapter 15 'if the action would be manifestly contrary to the public policy of the United States'.[1] This chapter discusses the exceptionally high burden parties must overcome to prove that requested relief is manifestly contrary to public policy, and states that in fact, bankruptcy courts make such findings only in extraordinarily rare circumstances.

Recognition of foreign insolvency proceedings in the United States

Chapter 15 was enacted in 2005 to 'incorporate the Model Law on Cross-Border Insolvency so as to provide effective mechanisms for dealing with cases of cross-border insolvency', and to facilitate cooperation between the courts and other competent authorities of the United States and of foreign countries in cross-border insolvency cases.[2] Chapter 15's adoption of the Model Law replaced section 304 of the Bankruptcy Code. Courts have noted that while section 304 relief was 'largely discretionary ... Chapter 15 improved predictability by mandating recognition when a foreign proceeding' meets certain statutory criteria.[3] This mandatory recognition 'fosters comity and predictability, and benefits bankruptcy proceedings in the United States that seek to administer property located in foreign countries that have adopted the Model Law'.[4]

Comity has been defined as

> *the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.*[5]

Courts have noted that comity is 'central' to and a 'principal objective' of Chapter 15.[6]

1 11 USC section 1506 (2016).
2 11 USC section 1501.
3 *In re ABC Learning Ctrs Ltd*, 728 F3d 301, 306 (3d Cir 2013).
4 Id.
5 *Hilton v Guyot*, 159 US 113, 164 (1895); *Ad Hoc Group of Vitro Noteholders v Vitro SAB De CV* (*In re Vitro SAB De CV*), 701 F3d 1031, 1043–44 (5th Cir 2012).
6 Id. at 1044.

To commence a Chapter 15 case, a foreign representative[7] authorised to administer a foreign debtor's assets must file a petition for recognition of a foreign proceeding in a US bankruptcy court.[8] After notice and a hearing, and subject only to the public policy exception, section 1506 of the Bankruptcy Code, the bankruptcy court must issue an order recognising the foreign proceeding if the following criteria set forth in section 1517 of the Bankruptcy Code are established:

- the foreign proceeding for which recognition is sought is a foreign main proceeding or foreign non-main proceeding;[9]
- the foreign representative applying for recognition is a person or body; and
- the petition for recognition meets requirements of section 1515.[10]

Upon recognition of a foreign proceeding under Chapter 15, the foreign representative is entitled to seek substantive relief in a bankruptcy court,[11] some of which is mandatory and some of which is discretionary. The relief available includes, among other things, 'the ability to sue and be sued in United States courts, to apply directly to a United States court for relief, to commence a non-Chapter 15 case, and to intervene in any United States case to which the debtor is a party'.[12] Importantly, like recognition of the foreign proceeding itself, the ability to obtain relief under Chapter 15 remains subject to section 1506.

The public policy exception

The public policy exception of section 1506 provides an exception to the presumption in favour of comity. Although the Bankruptcy Code does not define what 'manifestly contrary' to United States public policy means, legislative history and case law construe this language narrowly, and relief has been granted under section 1506 in only four cases to date (as discussed below in more detail).

7 11 USC section 101(24) defines 'foreign representative' as 'a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding'.

8 11 USC section 1504 (2016).

9 11 USC section 1502 defines a 'foreign main proceeding' as 'a foreign proceeding pending in the country where the debtor has the center of its main interests', and a 'foreign non-main proceeding' as 'a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment'.

10 11 USC section 1515 describes the requirements for a properly filed petition for recognition.

11 11 USC section 1509(b)(2); *In re Vitro SAB De CV*, 701 F3d at 1044.

12 Id.

In considering the exception, courts have noted that, while not dispositive, a 'prerequisite to applying section 1506 is that there exist[s] a conflict between foreign and US law'.[13] The public policy exception does not, however, extend to all US laws. While there is no statutory definition, '[t]he word "manifestly" in international usage restricts the public policy exception to the most fundamental policies of the United States.'[14]

The public policy analysis generally focuses on two factors, including 'whether the foreign proceeding was procedurally unfair', and whether granting the requested relief pursuant to Chapter 15 would seriously impact the value and significance of a US statutory or constitutional right, and hinder bankruptcy courts' abilities to carry out the fundamental purposes of such statutory or constitutional right.[15]

Examples of successful application of section 1506 in the context of recognition

Those who oppose the recognition of a proceeding under Chapter 15 'generally bear the burden of proof on applying public policy exceptions'.[16] This burden was successfully satisfied to avoid recognition of a foreign proceeding under Chapter 15 only two times in US history: *In re Toft*[17] and *In re Gold & Honey, Ltd.*[18]

In the first case, *In re Toft*, the Bankruptcy Court for the Southern District of New York refused to recognise a German insolvency proceeding as a foreign main proceeding because the foreign representative initiated the Chapter 15 proceeding for the sole purpose of gaining access to a German debtor's email accounts stored on US servers. The court found that:

> ... *the relief sought by the Foreign Representative is banned under U.S. law, and it would seemingly result in criminal liability ... for those who carried it out. The relief sought would directly compromise privacy rights subject to a comprehensive scheme of statutory protection, available to aliens, built on constitutional safeguards incorporated in the Fourth Amendment as well as the constitutions of many States.*[19]

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13 *Armada (Singapore) Pte Ltd v Shah* (*In re Ashapura Minechem Ltd*), 480 BR 129, 139 (SDNY 2012).

14 H.R. Rep. No. 109-31, pt. 1, at 109 (2005); *In re ABC Learning Centres Ltd*, 728 F.3d at 309 (quoting UNCITRAL Guide, ¶ 89, U.N. Doc A/CN.9/442 (1997)); *In re PT Bakrie Telecom Tbk*, 601 B.R. 707, 714 (Bankr. S.D.N.Y. 2019); *ASI, Inc v Foreign Liquidators (In re Manley Toys Ltd.)*, 2019 U.S. Dist. LEXIS 39023, at *15 (D.N.J. Mar. 12, 2019); *Vitro, S.A.B. de C.V. v. ACP Master, Ltd* (*In re Vitro, S.A.B. de C.V.*), 473 B.R. 117, 123 (Bankr. N.D. Tex. 2012); *In re Ashapura Minechem Ltd*, 480 B.R. at 139.

15 *In re Qimonda AG Bankr Litig*, 433 BR 547, 568–69 (ED Va 2010) (quoting *In re Gold & Honey, Ltd,* 410 BR 357, 372 (Bankr SDNY 2009)); *In re Manley Toys Ltd*, 580 BR 632, 648 (Bankr D.N.J. 2018), *aff'd, ASI, Inc. v Foreign Liquidators (In re Manley Toys Ltd.)*, 2019 U.S. Dist. LEXIS 39023 (D.N.J. Mar. 12, 2019); *In re Ir Bank Resolution Corp (In Special Liquidation)*, No. 13-12159 (CSS), 2014 Bankr LEXIS 1990, at *68 (Bankr D Del 2014); *In re Ashapura Minechem Ltd*, 480 BR at 139; *In re Vitro, SAB de CV*, 473 BR at 12.

16 *In re Ashapura Minechem Ltd*, 480 BR at 139; *In re PT Bakrie Telecom Tbk*, 601 B.R. at 724.

17 453 BR 186 (Bankr SDNY 2011).

18 410 BR 357 (Bankr SDNY 2009).

19 *In re Toft*, 453 BR at 198.

Furthermore, the court found that the foreign representative was seeking powers beyond those afforded to bankruptcy trustees under US law, as 'a trustee in bankruptcy is not entitled to a search warrant under the Federal Rules of Criminal Procedure.'[20]

In the case *In re Gold & Honey, Ltd*, the Bankruptcy Court for the Eastern District of New York refused to recognise an Israeli receivership proceeding based on the section 1506 exception. The petitioners asserted, among other things, that they were co-receivers for named debtors that were already in Chapter 11 proceedings pending before the Bankruptcy Court.[21] The court ruled that the petitioners were appointed as receivers in violation of the automatic stay as to the Chapter 11 debtors, and therefore that '[r]ecognition of the Israeli Receivership Proceeding as a foreign proceeding would be manifestly contrary to the public policy of the United States because such recognition would reward and legitimize ... violation of both the automatic stay and this Court's Orders regarding the stay.'[22]

Examples of successful application of section 1506 in the context of further relief

The only two additional cases where the public policy exception was applied were in the context of a foreign representative seeking specific Chapter 15 relief subsequent to recognition of a foreign main proceeding. In *In re Vitro SAB de CV*, the Court of Appeals for the Fifth Circuit affirmed a decision of the US Bankruptcy Court for the Northern District of Texas that refused, pursuant to sections 1521, 1507 and 1506 of the Bankruptcy Code, to enforce a Mexican plan of reorganisation that extinguished objecting creditors' guarantee claims under an indenture issued in the US against non-debtor subsidiaries of the debtor, holding that such relief was not warranted under those sections.[23] The court also held that the protection of third-party claims in an insolvency proceeding (or in other words, the policy against non-consensual, non-debtor releases or discharge) is a fundamental public policy of the US, and that because the Mexican plan does not recognise such rights, the 'plan is manifestly contrary to such policy of the United States and cannot be enforced here'.[24]

In *In re Qimonda AG Bankr Litig*,[25] a foreign representative of an already recognised foreign main proceeding filed a motion for relief under section 1521(a) of the Bankruptcy Code to modify a supplemental order of the Virginia Eastern Bankruptcy Court that made section 365 of the Bankruptcy Code (which governs the assumption or rejection of an executory contract by a debtor) applicable to the foreign proceeding. The foreign representative sought to eliminate the applicability of section 365(n) to rejections of contracts made in accordance with the German Insolvency Code, which would allow him to reject patent cross-licences without providing the licensee the option to retain its rights under the licence as provided under

20 Id.

21 *In re Gold & Honey, Ltd*, 410 BR at 360.

22 Id. at 371.

23 *In re Vitro, SAB de CV*, 473 BR at 132.

24 Id. The Fifth Circuit Court of Appeals did not reach this issue.

25 433 BR 547 (ED Va 2010).

section 365(n).[26] After parties to cross-licences with the debtor objected to such relief, the Bankruptcy Court ruled, among other things,[27] that failure to apply section 365(n) 'under the circumstances of this case and this industry would "severely impinge" an important statutory protection accorded licensees of US patents and thereby undermine a fundamental U.S. public policy promoting technological innovation.'[28] The Fourth Circuit affirmed the Bankruptcy Court's decision based on its analysis of section 1522(a), not section 1506. However, the Fourth Circuit stated that 'by affirming the bankruptcy court's application of § 365(n) following its balancing analysis under § 1522(a), we also indirectly further the public policy that underlies § 365(n).'[29]

The four cases described above are examples of extraordinary sets of facts that led to the application of the public policy exception. Even when enforcing the public policy exception, however, courts have limited the refusal to grant requested relief and, therefore, the refusal to grant comity, only to the extent the requested relief violates the public policy exception, and have also found that the public policy exception applies 'where the procedural fairness of the foreign proceeding is in doubt or cannot be cured by the adoption of additional protections'.[30] When procedural problems can be cured, the court will continue to extend comity.[31] For example, in *In re Ephedra Prods Liab Litig*,[32] the US District Court for the Southern District of New York found that an order approving a claims resolution procedure in Canada had certain provisions implicating important due process rights. However, upon the District Court's request, the foreign representative submitted amendments to the order curing those issues, which the Bankruptcy Court then recognised.[33]

However, as demonstrated by the decision granting recognition in the Chapter 15 case *In re Takata Corp*, Case No. 17-11713 (BLS) in the US Bankruptcy Court for the District of Delaware, as well as other cases where public policy arguments failed, courts are reluctant to apply the section 1506 exception without extraordinary circumstances.[34]

26 *In re Qimonda AG*, 462 BR at 168.

27 The Bankruptcy Court also ruled against the foreign representative, after balancing the interests of the debtor and the licensees, on the grounds that the relief requested does not satisfy section 1522(a) requirement that the interests of creditors and other interested parties, including the debtor, are sufficiently protected. Id. at 182–83.

28 Id. at 185.

29 *Jaffé v Samsung Elecs Co*, 737 F3d 14, 32 (4th Cir 2013).

30 *In re Qimonda AG Bankr Litig*, 433 BR at 570; *In re Ashapura Minechem Ltd*, 480 BR at 139; *In re Vitro, SAB de CV*, 473 BR at 133 (finding that the Mexican plan 'should not be accorded comity to the extent it provides for the extinguishment of the non-debtor guarantees of the indentures'.).

31 See generally *In re RSM Richter Inc v Aguilar* (*In re Ephedra Prods Liab Litig*), 349 BR 333 (SDNY 2006); see also *In re Toft*, 453 BR at 193.

32 349 BR 333 (SDNY 2006).

33 *In re Ephedra Prods Liab Litig*, 349 BR at 335.

34 Weil represented Takata's US subsidiaries in their Chapter 11 cases, but was not involved in the *Takata* Chapter 15 cases discussed herein.

In re Takata Corp

On 26 June 2017, Takata Corporation and two Japanese affiliates (collectively, the debtors) commenced civil rehabilitation proceedings under the Civil Rehabilitation Act of Japan before the Tokyo District Court (the Japanese proceedings). On 9 August 2017, Takata Corporation, asserting a capacity as the authorised foreign representative of the debtors (the foreign representative), filed Chapter 15 petitions and sought recognition of the Japanese proceedings as foreign main proceedings.

On 22 September 2017, plaintiffs in a litigation pending against the debtors in a different US court (the MDL plaintiffs) filed an objection to recognition of the Japanese proceedings on the grounds that recognition would be manifestly contrary to US public policy under section 1506 of the Bankruptcy Code.[35]

The MDL plaintiffs argued that recognition of the Japanese proceedings would constitute an unconstitutional denial of due process for US-based creditors in the Japanese proceedings.[36] Specifically, the MDL plaintiffs argued that their constitutional due process rights were violated because:

- the claims bar date in the Japanese proceedings was set for 60 days after the insolvency filings;
- the notice of the claims bar date was inadequate;
- US creditors were required to file proofs of claim in Japanese; and
- under Japanese law, if a claim is disapproved by the debtors and then also disallowed by the Japanese insolvency court upon review, the only available recourse to claimants is filing complaints seeking reexamination, the filing of which is subject to fees under Japanese law.[37]

By this time, the MDL plaintiffs' class action claims were disapproved by the debtors, but the MDL plaintiffs had not yet sought the Japanese's court determination on their class action claims. The MDL plaintiffs requested that these issues could be remedied by conditioning recognition on the allowance of their asserted class action claims.[38]

The foreign representative disputed that the Japanese proceedings prejudiced the MDL plaintiffs.[39] Furthermore, the foreign representative argued that Japanese bankruptcy law has been consistently 'upheld in the United States as bearing strong similarities to Chapter 11 cases and meeting US fundamental standards of fairness'.[40] The foreign representative pointed out that every one of the MDL plaintiffs actually received notice of the bar date and was able to

35 The Takata MDL Plaintiffs' Objection To The Verified Petition For Entry Of An Order Recognizing Foreign Main Proceedings, dated 22 September 2017 [ECF No. 62].

36 Id. at 2.

37 Id. at 8–11.

38 Id. at 12.

39 Foreign Representative's Reply to the Takata MDL Plaintiffs' Objection to the Verified Petition for Entry of an Order Recognizing Foreign Main Proceedings, 10 November 2017 [ECF No. 77].

40 Id. at 7.

file a timely claim.[41] Furthermore, the foreign representative argued that the MDL plaintiffs' objections to the requirement that the claims had to be in Japanese is without merit because they were unable to offer any case law indicating that there was a requirement that foreign jurisdictions allow filing proofs of claims in English.[42]

With respect to the notice period, the foreign representative pointed to provisions of Japanese law that allowed late-filed claims where the delay in filing was not due to the creditor's fault.[43] The foreign representative also addressed the MDL plaintiffs' argument regarding fees for filing complaints for re-examination in case of disallowance, arguing that because there are US laws that require bonds with respect to certain filings, there is no fundamental disagreement between the US and Japanese laws.[44]

Finally, the foreign representative argued that there is no fundamental US policy requiring acceptance of class action claims and, in fact, that such claims are prohibited as a matter of law in certain jurisdictions in the US.[45] The foreign representative argued that by objecting to recognition, the MDL plaintiffs were merely seeking to avoid having to defend their claims, which had already been disapproved, in Japanese court.[46]

Ruling

The Bankruptcy Court for the District of Delaware overruled the MDL plaintiffs' objection and entered an order recognising the Japanese proceedings as a foreign main proceeding.[47] The court stressed that it 'is obliged, as reflected in the mandatory nature of [s]ection 1517, to err on the side of finding recognition, subject only to what … is treated uniformly in the case law as a narrow exception'.[48] Furthermore, the court found that 'recognition is not manifestly contrary to US public policy',[49] and that it is not willing to condition recognition on the allowance of the MDL plaintiffs' class proofs of claim.[50]

Discussion of the arguments during the hearing

The Bankruptcy Court found during the hearing that with respect to the various due process concerns, there were no fundamental differences between Japanese and US law. With respect to the 'timeline, the sufficiency of notice, and the process of providing notice to claimants', the court pointed out that nearly identical objections are brought before the court in other cases under US law, and that in some cases, the language of the Japanese law actually offers

41 Id. at 10.
42 Id. at 13–14.
43 Id. at 11.
44 Id. at 15.
45 Id. at 4, 17–18.
46 Id. at 17.
47 Order Granting Final Relief for Recognition of Foreign Main Proceedings, 14 November 2017 [ECF No. 86].
48 Transcript of Hearing Before Honorable Brendan L. Shannon, United States Bankruptcy Judge, 14 November 2017, at 9:00 am, at 43 [ECF No. 87].
49 Id. at 44.
50 Id.

more protection to creditors than US law does, because the Bankruptcy Code only requires 21 days' notice of the claims bar date, as opposed to the 60-day Japanese law requirement.[51] Similarly, with respect to MDL plaintiffs' complaint regarding the Japanese-language filing requirement, the court pointed out that just as a claimant in Japan has to file a claim in Japanese, a claim filed in the US would have to be translated into English, and so there is no conflict between the laws of the two countries.[52]

With respect to the MDL plaintiffs' argument that may be deprived of a right to a class action claim under Japanese law, the court agreed with the foreign representative that a right to a class action is not a fundamental right, also stating that, '[a] class action is not in the bill of rights.'[53]

Conclusion

As demonstrated in *Takata*, the burden to overcome the presumption in favour of recognition of a foreign proceeding based on the public policy exception in section 1506 of the Bankruptcy Code is difficult to meet, even when the issues at stake are due process or litigation rights. It is not enough that a creditor may get a different result under US law. It is also not enough that a US law is in conflict with the foreign law in question. The only cases where this burden was met included elements of egregiousness and lack of fundamental fairness that cannot be easily demonstrated by creditors under the section 1506 public policy exception.

* *The authors would like to thank Weil associate Mary Bischoping for providing valuable contributions to this chapter.*

51 Id.

52 Id at 23.

53 Id. at 20.

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US: How Foreign is Too Foreign?

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In summary

This chapter reviews the history and current state of case law addressing whether, under the US Bankruptcy Code, a trustee's power to recover fraudulently transferred property applies extraterritorially to property that was transferred between foreign parties, and related questions over the foreign or domestic nature of such transfers.

Discussion points

- The interaction between Bankruptcy Code Sections 550(a)(2) and 541
- Historic approaches to extraterritoriality taken in the *In re Maxwell* and *In re French* cases
- The Morrison test and US Supreme Court jurisprudence on extraterritorial application and determining the foreign or domestic 'focus' of statutes
- Divergent application of the Morrison test to foreign transfers in two cases arising out of the Madoff proceedings in the Southern District of New York
- The Second Circuit's approach in *In re Picard* to these questions and to related questions of international comity

Referenced in this article

- US Bankruptcy Code Section 550
- US Bankruptcy Code Section 541
- *In re Maxwell Commc'n Corp plc*, 186 BR 807 (SDNY 1995)
- *In re French*, 440 F3d 145 (4th Cir 2006)
- *Morrison v Nat'l Australia Bank*, 561 US 247 (2010)
- *RJR Nabisco, Inc. v European Cmty*, 136 S Ct 2090 (2016)
- *WesternGeco LLC v ION Geophysical Corp*, 138 S Ct 2129 (2018)
- *Sec Inv'r Prot Corp v Bernard L Madoff Inv Sec LLC*, 480 BR 501 (Bankr. SDNY 2012)
- *Sec Inv'r Prot Corp v Bernard L Madoff Inv Sec LLC*, 513 BR 222 (SDNY 2014)
- *In re Picard*, 917 F3d 85 (2d Cir 2019)

Introduction

Section 550(a)(2) of the US Bankruptcy Code allows a trustee to recover property that is the subject of an avoided transfer from 'any immediate or mediate transferee' of an initial transferee. Whether this power to recover extends to property that was transferred from a foreign initial transferee to a foreign subsequent transferee has long been an unresolved question. In recent years, several courts have weighed in on the question, clarifying and refining the framework for answering it with respect to individual transfers in specific cases. While the recent case law has provided more guidance to litigants, several open questions remain. In this chapter, we discuss the current landscape with respect to the application of section 550(a)(2) to foreign-to-foreign transfers, how a recent Second Circuit decision has altered the terrain, and the questions that remain unanswered.

The basic question: how do Code sections 550(a)(2) and 541 interact?

Under Code section 541, 'property of the estate' is defined expansively to include certain categories of property 'wherever located and by whomever held'. These categories of property include '[a]ny interest in property that the trustee recovers under [section 550]'. Section 550(a)(2) allows a trustee to 'recover, for the benefit of the estate', property transferred to 'any immediate or mediate transferee' of an initial transferee, 'to the extent that [the] transfer is avoided' under one of several avoidance sections provided elsewhere in the Code.

Trustees in a number of bankruptcy proceedings have argued that their recovery powers under section 550(a)(2) extend to property that was the subject of an overseas (or foreign-to-foreign) transaction. To support this argument, these trustees have generally either relied on the broad definition of 'property of the estate' in section 541, or on the notion that this type of transaction, in certain instances, should be considered 'domestic', so that recovery of the assets transferred would not require extraterritorial application of the Code section in the first place.

The pre-Madoff framework: Maxwell, French and Morrison

In re Maxwell[1]

The seminal *Maxwell* case cemented comity and a presumption against extraterritoriality as the twin principles guiding US courts addressing the extraterritorial reach of US insolvency law. The case involved an English debtor corporation and centred on a series of transfers by foreign transferors to foreign recipients that were otherwise avoidable under section 547. The Bankruptcy Court for the Southern District of New York declined to permit recovery of these transfers, reasoning that 'neither the language nor legislative history of section 547 or the bankruptcy code as a whole evinced Congress's intent to apply section 547 to conduct occurring outside the borders of the US.' On appeal, the district court endorsed the

1 *In re Maxwell Commc'n Corp plc, 186 BR 807* (SDNY 1995), aff'd sub nom. *In re Maxwell Commc'n Corp plc*, 93 F3d 1036 (2d Cir 1996).

Bankruptcy Court's analysis, but held that, separate and apart from the presumption against extraterritoriality, principles of international comity counselled against extraterritorial application of the US Bankruptcy Code.

The district court began by recognising that the presumption against extraterritoriality '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'. The presumption 'serves to protect against unintended clashes between our laws and those of other nations which could result in international discord'. The court articulated a 'two-fold inquiry' for application of the presumption: 'First, a court must determine if the presumption applies at all'; in other words, the court must determine whether the 'conduct [at issue] occurred outside of the borders of the US.' If the court determines that the presumption applies, it must then determine whether 'Congress intended to extend the coverage of the relevant statute to such extraterritorial conduct'.

The court determined that the transactions at issue 'clearly' occurred overseas, but it declined to rest this decision solely on the basis that the transfers were made from and to bank accounts located outside of the United States. It noted that 'such a limited conception of "transfer" for purposes of an extraterritoriality analysis would have potentially dangerous implications', because a creditor seeking to have a transfer characterised as extraterritorial 'could simply arrange to have the transfer made overseas'. Instead, the court noted, the analysis requires a consideration of 'all component events of the transfers'.

In performing the analysis, the court determined that the transferors and transferees were all foreign entities whose relationships were 'centered in England'. The debts underlying the payments had been made and maintained in England, and were governed by English law. The only connection to the US was that the payments represented proceeds from a sale of US assets, a sale that depleted the bankruptcy estate. The court dismissed the importance of this connection, however, holding that the sale was 'more appropriately characterized as a preparatory step to the transfers'.

The court implicitly left open the possibility that the presumption might not apply to foreign defendants who subjected themselves to the equitable claims adjustment process by submitting a proof of claim. It declined to make such a finding in this case because, although the foreign defendants had submitted proofs of claim, they had done so only in a parallel proceeding in England.

Having determined that the transfers at issue were extraterritorial, the court turned to the second step of its inquiry: whether Congress intended section 547 of the Bankruptcy Code to apply extraterritorially. It stated that a statute will not be applied extraterritorially 'unless the affirmative intention of the Congress to apply the law extraterritorially is clearly expressed in the statute' and that 'any ambiguity in the statute must be resolved in favor of refusing to apply the law to events occurring outside US territory'.

The court declined to find Congressional intent to apply section 547 of the Bankruptcy Code extraterritorially. First, it rejected an argument that extraterritoriality was implied by the words 'any transfer' in section 547, explaining that this type of 'boilerplate language' is 'insufficient to overcome the presumption against extraterritoriality' and noting that the parties had not pointed to any legislative history that would alter this conclusion. Next, it rejected an argument that the definition of 'property of the estate' in section 541 (to include property 'wherever located') mandated extraterritorial application, reasoning that property is not 'property of the estate' until after it has been recovered.

Having concluded that section 547 could not be applied extraterritorially, the court offered comity as a separate and independent ground to block recovery of the transfers at issue in the case. It noted that '[c]omity is wholly independent of the presumption against extraterritoriality and applies even if the presumption has been overcome or is otherwise inapplicable.' Since the transfers at issue 'occurred in England on account of debt incurred there', and 'most creditors [of the overseas transferor] are English', the court held that 'the effect on US creditors of the transfers is outweighed by the effects of the transactions in England.'

In re French[2]

A decade later, the Court of Appeals for the Fourth Circuit in *In re French* applied the analysis laid out in *Maxwell* to the transfer of real estate located in the Bahamas, but reached the opposite conclusion:

- recovery of the property at issue, although its transfer took place abroad, did not require extraterritorial application of the recovery statute;
- in any event, Congress intended the recovery statute to be applied extraterritorially; and
- comity did not bar recovery of the transferred property.

The subject property was a house in the Bahamas that had been transferred by the debtor to her children, as a gift, at a time when the debtor was already insolvent.[3] The court noted that both the debtor and her children were located in the United States; that the decisions to transfer the property and to make the transfer a gift had also been made there; and that recordation of the deed in the Bahamas was 'at most incidental' to the conduct regulated by the fraudulent-transfer statute. The court concluded that the transfer of the house was therefore a domestic transfer, so that its recovery did not require extraterritorial application of any Bankruptcy Code section.

The court did recognise that the Bahamas had a 'powerful interest' in real property within its boundaries – an interest that 'perhaps merits special weight in the balancing test'. However, the court determined that it did not need to 'resolve this slippery question' because even if recovery of the property required extraterritorial application of the Bankruptcy Code, there was sufficient evidence of congressional intent favouring such application that the presumption against extraterritoriality was rebutted. Acknowledging the existence of a circuit split regarding the question, the court sided with Fifth Circuit precedent to hold that the 'property of the estate' includes property that would have been property of the estate

2 440 F.3d 145 (4th Cir. 2006).

3 Unlike the transfers at issue in *Maxwell* and the other recovery cases discussed in this chapter, the transfer in *In re French* was an 'initial transfer,' made directly by the debtor to a transferee, and recoverable under section 550(a)(1) of the Bankruptcy Code.

but for the fraudulent transfer. It then reasoned that the definition of 'property of the estate' in section 541 (which includes property 'wherever located') 'demonstrated an affirmative intention [by Congress] to allow avoidance of transfers of foreign property that, but for a fraudulent transfer would have been property of the debtor's estate'.

Finally, the court determined that comity would not block recovery of the Bahamian property. It rested this decision on a determination that it would be more appropriate to apply US law to the transfer than Bahamian law: most activity surrounding the transfer took place in the US, almost all the parties with an interest were located in the US, and the debtor had a strong connection to the US. In addition, because no parallel insolvency proceedings were taking place in the Bahamas, there was no risk of conflicting judicial opinions. The court concluded that 'applying Bahamian law here would undercut the purpose of the United States Bankruptcy Code by withdrawing its protections from those it is intended to cover, while simultaneously failing to protect any Bahamian residents.'

Morrison, Nabisco and WesternGeco

The extraterritoriality question reached the US Supreme Court in 2010. In *Morrison v National Australia Bank*,[4] a securities fraud case, the Supreme Court proceeded from the principle that there exists a presumption against extraterritorial application of statutes. It outlined a two-step approach for determining whether in a given case this presumption blocks recovery of property involved in an avoided foreign-to-foreign transfer. First, the court is to determine whether the presumption has been rebutted, by examining whether Congress intended the statute to apply extraterritorially. Second, if the presumption against extraterritoriality has not been rebutted, the court is to determine whether the litigation involves extraterritorial application of the statute.[5] The court emphasised that the presumption against extraterritoriality is not a 'clear statement rule' – a court can look beyond the words of the statute and review the statute in context – but it made clear that in seeking to overcome the presumption, 'uncertain indications do not suffice'.

In the subsequent *Nabisco* decision, in which the Supreme Court was called upon to apply the *Morrison* test in a RICO context,[6] the first step of this inquiry was phrased as follows: 'If the statute is not extraterritorial then at the second step we determine whether the case involves a domestic application of the statute, and we do this by looking to the statute's "focus".'

In the recent *WesternGeco* decision, discussed below, the Supreme Court further elucidated that the 'focus' of a statute is '"the object of its solicitude," which can include the conduct it "seeks to regulate," as well as the parties and interest it "seeks to protect" or vindicate'. The Supreme Court advised that analysis of a statute's focus should not occur 'in a vacuum' but should assess the statute 'in concert with other provisions' with which it works 'in tandem', and with a view to determining 'how the statute has actually been applied'.

4 561 U.S. 247 (2010).

5 As described below, the two-step *Morrison* test is often applied in reverse order.

6 *RJR Nabisco, Inc v European Cmty*, 136 S. Ct. 2090 (2016).

The Madoff cases: divergent application of the Morrison test to section 550

Two of the first opinions applying the *Morrison* test to recovery of fraudulent transfers reached diametrically opposite conclusions. Both opinions were rendered in adversary proceedings arising out of the Bernard Madoff Ponzi scheme, and involved offshore 'feeder funds' that pooled capital from investors worldwide for investment in Madoff Securities. The feeder funds had received distributions from Madoff Securities, which they transferred to their foreign customers.

BLI[7]

In what is commonly referred to as the *BLI* matter, the trustee for the Madoff Securities estate sought to recover certain transfers received by foreign entities, including the Taiwanese Bureau of Labour Insurance (BLI), via one of the largest feeder funds for Madoff Securities.

The US Bankruptcy Court for the Southern District of New York applied the *Morrison* steps in reverse order.[8] First, it determined that the 'focus' of the avoidance and recovery sections in the Bankruptcy Code is on the initial transfer, from the bankruptcy estate to an initial transferee, since it is this initial transfer that depletes the estate. The court explained that 'if the acts or objects upon which the statute focuses are located in the United States, application of the statute is domestic and the presumption against extraterritoriality is not implicated, even if other activities or parties are located outside the United States'. Because Madoff Securities was located in New York, the court held that the relevant transfers were domestic and application of section 550 to recover transferred assets would not be extraterritorial, even if the recovery involved a subsequent transferee located abroad.

Second, although the court found that recovery of the transferred assets in this case did not call for extraterritorial application of the avoidance provisions, it determined that the statutory context showed Congress's intent to allow such application. Congress demonstrated this intent through 'interweaving terminology and cross-references' by:

- defining 'property of the estate' in section 541 to include all property worldwide;
- incorporating the language 'interest of the debtor in property' in avoidance sections 544, 547, and 548; and
- explicitly authorising recovery of all avoided transfers in section 550.

The court added that disallowing recovery of assets fraudulently transferred abroad would 'render hollow the avoidance and recovery provisions of the Code, an outcome clearly unintended by Congress'. It distinguished the SDNY's findings in *Maxwell* on the basis that the *Maxwell* debtor was located outside the United States, so that depletion of the estate in that case occurred abroad.

7 *Sec. Inv'r Prot. Corp. v Bernard L. Madoff Inv. Sec. LLC* (BLI), 480 B.R. 501 (Bankr. S.D.N.Y. 2012).

8 Before performing the *Morrison* analysis, the court determined that it had personal jurisdiction over BLI through a 'minimum contacts' analysis.

Finally, the court held that considerations of comity did not bar recovery of the transferred assets, distinguishing the *Maxwell* court's comity decision as having 'no applicability to the instant case', because BLI was not involved in parallel liquidation proceedings in a foreign country.

ET – District Court[9]

In a different adversary proceeding emanating from the Madoff Securities bankruptcy, the District Court for the Southern District of New York reached the opposite conclusion from the *BLI* court.

Applying a *Morrison/Nabisco* analysis, the court first determined that recovery of the transfers at issue would require extraterritorial application of section 550. The 'focus' of the section, according to the court, was on 'the property transferred and the fact of its transfer', not on the debtor. Applying the 'component events' test articulated in *Maxwell*, the court observed that the transfers and transferees involved in the proceeding were predominantly foreign, and that the funds' origination at Madoff Securities in New York was insufficient to render them domestic. The court also rejected the argument that the use of correspondent banks in the US to execute the transfers would render the transfers domestic.

The court next concluded that Congress did not evince 'clear intent' to permit extraterritorial application of section 550. It rejected the relevance of section 541's definition of 'property of the estate', citing Second Circuit precedent for the proposition that 'preferential transfers do not become property of the estate until recovered.'[10] On the basis of this precedent, the court declined to follow *In re French*. In doing so, it noted that *In re French* was distinguishable in any event, since it involved transfer activity that took place in the US as well as parties based in the US. The court brushed aside an argument (endorsed by the *Maxwell* court) that barring extraterritorial application of section 550 would allow debtors and creditors to avoid recovery by arranging for their transfers to occur abroad, reasoning that 'the desire to avoid such loopholes in the law must be balanced against the presumption against extraterritoriality'.

Finally, the court cited comity as an independent ground for disallowing recovery from the foreign transferees. It reasoned that, since many of the feeder funds were involved in foreign liquidation proceedings, investors in foreign funds 'had no reason to expect that U.S. law would apply to their relationships with the feeder funds'. The court added that given the 'indirect relationship between Madoff Securities and the transfers … foreign jurisdictions have a greater interest in applying their own law than does the United States'.

9 *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC* (ET), 513 B.R. 222 (S.D.N.Y. 2014).

10 ET, 513 B.R. at 228-230, citing *In re Colonial Realty Co.*, 980 F.2d 125, 131 (2d Cir. 1992)).

The court did not dismiss any of the pending claims, instead remanding the case to the bankruptcy court, to determine which claims should be dismissed for being 'purely foreign transfers'.

ET – on remand[11]

Before the bankruptcy court could address the issues left on remand, parties to more than 80 parallel adversary proceedings filed motions to dismiss on, among other things, extraterritoriality grounds, relying on the district court's decision. The court issued an omnibus decision addressing the motions together.

The judge[12] noted the stark differences between the *BLI* and *ET* decisions, and construed his task narrowly: to review the allegations 'to determine whether they survive dismissal under the extraterritoriality or comity principles enunciated in the *ET* decision'.

The court first examined the claims under principles of comity. Most claims based on transfers originating in feeder funds that were subject to a foreign liquidation proceeding were dismissed on the basis of comity.[13] Although the court noted that a finding of 'comity among nations does not require parallel proceedings', it did not engage in a comity analysis for the remaining transfers.

The court next performed a detailed extraterritoriality analysis, painstakingly analysing the numerous claims one by one to determine 'the critical factor – where the transfer occurred'. The court stated that the *ET* decision 'identifie[d] only four possibly relevant facts to consider in determining whether the Trustee has rebutted the presumption against extraterritoriality:

- the location of the account from which the transfer was made;
- the location of the account to which the transfer was made;
- the location or residence of the subsequent transferor; and
- the location or residence of the subsequent transfer'.

Applying these criteria, the court dismissed a 'substantial number' of the remaining claims on the basis of extraterritoriality, as they did not allege a relevant nexus with the United States.

11 *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, No. AP 08-01789 (SMB), 2016 WL 6900689 (Bankr. S.D.N.Y. Nov. 22, 2016), petition for direct appeal docketed, No. 17-1341 (2d Cir. April 28, 2017).

12 The omnibus decision on remand from ET was written by Judge Bernstein. The BLI decision had been written by Judge Lifland.

13 Claims against three of these defendants were upheld because the court had not received sufficient information about the foreign liquidation proceedings to reach a conclusion.

Madoff appeal

The Madoff Securities trustee filed a petition for leave to appeal the *ET* district court decision and the subsequent decision on remand to the Court of Appeals for the Second Circuit,[14] presenting the court with two questions:

- whether the Bankruptcy Code and the Securities Investor Protection Act 'permit the recovery of property fraudulently transferred by the debtor when it has been subsequently transferred in transactions with allegedly extraterritorial components'; and
- '[w]hether the comity of nations independently bars recovery of such property.'

The petition was granted on 27 September 2017.[15]

In re Picard

In a carefully written opinion that confined itself to the specific facts presented, the Second Circuit in *In re Picard* resolved the split between the *Madoff* district court decisions by finding that the Madoff trustee could recover for alleged fraudulent transfers that occurred between foreign initial and subsequent transferees.

The Second Circuit reached its conclusion through a novel analysis and a narrower ruling in comparison to that of the lower courts. Instead of announcing a bright-line rule on the extraterritorial application of section 550(a) under the first step of *Morrison*, the *Picard* court proposed a new conceptual framework under the second step of *Morrison* for analysing whether, in a given case, section 550(a) involves domestic or extraterritorial conduct.

The *Picard* court determined that, taken together, sections 548(a)(1)(A) and 550(a) focus on the initial transfer of the debtor, and that, as a result, the transactions at issue in the Madoff cases should be considered domestic applications of the statute, notwithstanding the fact that subsequent transfers may have occurred entirely between foreign entities. The court also determined that, based on the facts before it, comity concerns did not bar the Madoff trustee from seeking to recover fraudulent transfers from foreign initial or subsequent transferees. The Second Circuit vacated the judgments of the *ET* bankruptcy court dismissing the Madoff trustee's actions and remanded the case for further proceedings.

14 Pet. Of Appellant Irving H. Picard for Permission to Appeal Pursuant to 28 U.S.C. § 158(d)(2)(A), Case No. 17-1341 (2d Cir. April 28, 2017).

15 Docket No. 388 (Order), Case No. 17-1294 (2d Cir. Sept. 27, 2017).

Morrison/Nabisco/WesternGeco analysis

The *Picard* court began by reviewing the operative provisions of the Bankruptcy Code that the Madoff trustee relied upon: sections 548(a) (1)(A)and 550(a).[16] The Madoff trustee alleged that Madoff Securities' initial transfers to feeder funds were avoidable as fraudulent under section 548(a)(1)(A). Section 548(a)(1(A) provides, in relevant part, that '[t]he trustee may avoid any transfer … of an interest of the debtor in property, or any obligation … incurred by the debtor', provided the debtor 'voluntarily or involuntarily … made such transfer … with actual intent to hinder, delay, or defraud … .'[17] The Madoff trustee sought to reclaim such fraudulent transfers under the recovery provisions of section 550(a), in particular from foreign subsequent transferees of the foreign feeder funds.

The lower court in ET had dismissed the Madoff trustee's action after finding under *Morrison/Nabisco* that Congress did not evince a 'clearly expressed' intent that section 550(a) should have extraterritorial reach and the transactions did not involve a domestic application of the statute. The *Picard* court reviewed these determinations de novo.

Rather than analyse the *Morrison* questions in the order posed by the Supreme Court, the *Picard* court found this 'an appropriate case for beginning with the latter question' – whether the case involved a domestic application of the statute. The court first assessed whether, per *Nabisco*, 'the conduct relevant to the statute's focus occurred in the United States'.[18] The court's approach to analysing the 'focus' of section 550(a) was influenced by the Supreme Court's recent decision in *WesternGeco*, which examined the extraterritorial application of provisions of the Patent Act. According to *WesternGeco*, courts must not 'analyze the provision at issue in a vacuum' when determining a statute's focus. Instead, '[i]f the statutory provision at issue works in tandem with other provisions, it must be assessed in concert with those other provisions'. Courts must also consider the conduct that a statute 'seeks to regulate' and the 'parties and interests it seeks to protect or vindicate'.

The *Picard* court took the teachings of *WesternGeco* to heart in fashioning a new framework for analysing the 'focus' of section 550(a). First, the court found that in order to properly assess the focus of section 550(a), it must not consider the provision 'in a vacuum'. Because section 550(a) is a recovery provision that can apply 'only to the extent that a transfer is avoided' pursuant to an avoidance provision of the Bankruptcy Code, the two provisions necessarily work 'in tandem'.

The *Picard* court accordingly held that 'to determine § 550(a)'s focus in a given action, a court must also look to the relevant avoidance provision', whether that is section 548(a)(1(A) or another provision identified in section 550(a).

16 The Madoff trustee was appointed pursuant to the Securities Investor Protection Act (SIPA) and argued that certain provisions of SIPA provided additional reasons for the court to find that section 550(a) focused on domestic conduct. Because the court reached its holding without relying on SIPA, it 'express[ed] no opinion on whether SIPA is relevant to the focus of the Bankruptcy Code's avoidance and recovery provisions in cases where SIPA trustees seek to use them'. Picard, 917 F3d at 100.

17 11 USC § 548(a)(1)(A).

18 *Nabisco*, 136 S Ct at 2101. 22 ET, 513 BR at 231.

Second, the court found that when section 550(a) is considered in tandem with section 548(a)(1(A), section 550(a) should be read as regulating the debtor's fraudulent transfer of property. Section 548(a) (1(A) allows a trustee to 'avoid any transfer … of an interest of the debtor in property' that the debtor 'made … with actual intent to hinder, delay, or defraud'. The court found the purpose of this provision to be 'plain: it allows a trustee, for the protection of an estate and its creditors, to avoid a debtor's fraudulent … transfer that depletes the estate'. Quoting bankruptcy expert Edward Morrison, the *Picard* court stated that section 550(a) is a 'utility provision, helping execute the policy of § 548[(a)(1)(A)]' by 'tracing the fraudulent transfer to its ultimate resting place (the initial or subsequent transferee)'.

On this basis, the *Picard* court held that 'in recovery actions where a trustee alleges a debtor's transfers are avoidable as fraudulent under § 548(a)(1)(A), § 550(a) regulates the fraudulent transfer of property depleting the estate', and thus regulates the debtor's initial transfer. Therefore the focus of section 550(a) is on the initial transfer from Madoff Securities to the feeder funds, and not on subsequent overseas transfers made by the feeder funds. The court found that the lower courts, which held that section 550(a) regulated only the subsequent transfer of property, had erred by failing to consider how '§ 548(a)(1)(A) shape[d] the focus of § 550(a)'.

Finally, the *Picard* court analysed the initial transfers of debtor Madoff Securities and determined that they involved a domestic application of the statute. Madoff Securities was a domestic debtor based in New York and the alleged fraud occurred when the debtor transferred property from US bank accounts. On this basis, the court held that the transfers were 'domestic activity for the purposes of §§ 548(a)(1)(A) and 550(a)', and that 'the presumption against extraterritoriality therefore does not prohibit the debtor's trustee from recovering such property using § 550(a), regardless of where any initial or subsequent transferee is located'.

The *Picard* court also indicated that its resolution of the case provided the best policy outcome. The court noted that if the approach in ET were followed and the court focused on the transferee's receipt of property, instead of the debtor's transfer, this would 'open a loophole' for persons on the verge of bankruptcy to transfer assets outside the reach of the Bankruptcy Code and its creditor-protection provisions. The court refused to read *Morrison* and the Bankruptcy Code in this 'self-defeating way'.

Because the *Picard* court found that the case involved a domestic application of section 550(a), it declined to opine on whether section 550(a) indicates its extraterritorial application under *Morrison* step one.

Comity

The *Picard* court then assessed whether the lower courts' dismissal of the Madoff trustee's actions on international comity grounds was proper. The lower courts had found that comity principles required a 'choice-of-law analysis to determine whether the application of US law would be reasonable under the circumstances, comparing the interests of the United States and the relevant foreign state'. Applying this analysis, the lower courts found that comity barred the application of US law here. The *Picard* court interpreted this question as one of 'prescriptive' comity, which requires the court to determine whether, as a matter of statutory interpretation, it should presume that Congress limited the application of domestic law in certain situations out of respect for foreign sovereigns.[19] The court reviewed the comity question de novo, and found that the lower courts had erred.

The *Picard* court applied the choice-of-law test from the *Maxwell* case, which 'takes into account the interests of the United States, the interests of the foreign state, and those mutual interests the family of nations have in just and efficiently functioning rules of international law'.[20] First, the *Picard* court noted that the 'United States has a compelling interest in allowing domestic estates to recover fraudulently transferred property'. When a debtor in American courts is also in foreign liquidation proceedings, the foreign state 'has at least some interest in adjudicating property disputes', which '[i]n appropriate cases … will trump our own'. The court noted that there were no such parallel proceedings in this case, because only the feeder funds, not Madoff Securities, had filed as debtors in foreign courts. The court found that 'the absence of such [parallel] proceedings seriously diminishes the interest of any foreign state' in how the matters were resolved.

The court did recognise that foreign states adjudicating the feeder funds' liquidations would have an interest in the Madoff trustee's actions, since if the Madoff trustee succeeded in his recovery attempts, it might 'frustrate' the efforts of the feeder funds' trustees to recover the same property. But the court determined that those interests did not implicate 'the comity concerns our precedent discusses in explaining when and why the Bankruptcy Code should give way to foreign law', because the proceedings in question were not duplicative of the US action.[21] The court therefore concluded that, under the *Maxwell* test, the United States' interest in applying its law outweighed that of any foreign state and that under the facts presented, prescriptive comity posed 'no bar to recovery' of property under section 550(a) from a foreign subsequent transferee, 'even if the initial transferee is in liquidation in a foreign nation'.

As with the extraterritoriality analysis, the *Picard* court found that the lower courts erred in their comity analysis by focusing on the subsequent transfers to foreign transferees, as opposed to the debtor's initial transfer, which was domestic in nature and implicated the United States' interests.

19 The second form of comity is 'adjudicative' comity, which asks whether a court should abstain from exercising jurisdiction in deference to a foreign nation's courts that might be a more appropriate forum for adjudicating the matter. The appellees in *Picard* raised adjudicative comity as a separate basis for arguing that the court should decline to exercise jurisdiction, but only did so in a footnote. The Picard court thus did not consider the issue to have been 'adequately raised' for appellate review. *Picard*, 917 F3d at 102 No. 14.

20 *Maxwell*, 93 F3d at 1048.

21 'The Bankruptcy Code gives us no reason to think Congress would have decided that trustees looking to recover property in domestic proceedings are out of luck when trustees in foreign proceedings may be interested in recovering the same property'. *Picard*, 917 F3d at 104-05.

Result and effects

The *Picard* court permitted the Madoff trustee to seek avoidance and recovery of alleged fraudulent transfers involving foreign transferees, in alignment with the outcomes in the *BLI* and *In re French* cases. But given the narrow ruling in *Picard*, it remains to be seen just how much the decision will affect the litigation landscape concerning this issue.

On the one hand, and in contrast to *BLI* and *In re French*, the *Picard* court declined to reach the larger question of section 550(a)'s extraterritorial application under the first step of *Morrison*. Such a ruling might have encouraged litigation against foreign recipients of fraudulently transferred assets. As it is, the *Picard* decision sets out an analytical framework for litigants to argue that an application of section 550(a) involves domestic conduct under *Morrison* step two. But the outcome of that analysis in the context of other fact patterns, and under other avoidance provisions of the Bankruptcy Code, is uncertain.

On the other hand, the *Picard* decision can be read to suggest that permitting domestic trustees to reach assets of foreign transferees is not only the right policy outcome, but also permissible under, and intended by, the Bankruptcy Code. This may lead plaintiffs to believe that the Second Circuit would be inclined to find that section 550(a) has extraterritorial effect, if made to confront the issue in a future case.

Petition for certiorari and unresolved questions

The Picard court ruled narrowly on the issues raised by the Madoff trustee, leaving many open questions. In particular, while numerous observers had hoped for a conclusive resolution of the extraterritorial application of section 550(a), the court pointedly declined to render an opinion on it. That desired clarity could potentially be forthcoming. On 29 August 2019, the defendant appellees in *Picard* filed a petition for certiorari with the US Supreme Court, in which they asked the court to decide whether the application of section 550(a)(2) to recover proceeds of a foreign transaction between foreign parties was in fact a domestic application for the purpose of an extraterritoriality analysis, as the *Picard* court held.[22]

Even if the Supreme Court grants the petition, one can only speculate to what extent its resolution of petitioners' questions will shed light on the question of whether the avoidance provisions of section 550 ought to have extraterritorial effect. For instance, if the court ultimately affirms the *Picard* court's treatment of the transfers as domestic, it could entirely avoid weighing in on the debate over the extraterritorial application of section 550(a). In that case, within the Second Circuit, the extraterritoriality question would remain subject to the contrasting opinions of the *BLI* and ET courts. If, however, the court were to disagree with the analysis or outcome in *Picard*, it might conceivably use that opportunity to opine more broadly on whether avoidance provisions may have extraterritorial effect.

22 Petition for Writ of Certiorari, *HSBC Holdings PLC v Picard*, 2019 WL 4190391 (U.S.) (No. 19-277). The petitioners also asked the Court to determine if the Second Circuit should have reviewed the comity question for abuse of discretion, instead of de novo.

Until such time, it will fall to litigants and lower courts to parse and apply the *Picard* framework when determining if conduct is domestic or foreign, and to continue the ongoing debate over the extraterritorial application of section 550.

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Investment Fund Activity in Chapter 11

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In summary

This chapter examines the role hedge funds and private equity funds have come to play in US bankruptcy cases, and the variety of investment strategies they deploy in distressed situations, including in connection with debtor-in-possession and exit financing, pre-negotiated and pre-packaged Chapter 11 cases, and various litigation scenarios.

Discussion points

- Conditions leading to increased investment fund participation in US bankruptcy cases
- Overview of notable investment fund strategies
- Recent trends in investment fund tactics in large Chapter 11 cases and distressed situations

Referenced in this article

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Introduction

Hedge fund and private equity fund participation in US bankruptcy cases has proliferated in the past decade. Funds specialising in distressed investments now appear in almost every large Chapter 11 case, and often play a significant role in shaping the course and outcome of the case. This trend shows no signs of stopping. Instead, investment funds continue to be a strong force in Chapter 11, as sophisticated investors who are adept at finding creative ways to maximise their returns. This article examines some of the investment strategies that funds have deployed in response to current market conditions.

Background

The global financial crisis that began in September 2008 precipitated a huge increase in Chapter 11 filings: nearly 20 times more debt was restructured through Chapter 11 in 2008 and 2009 than in the two preceding years. Not only did the total number of bankruptcy filings increase, the size and complexity of companies seeking bankruptcy protection also grew considerably. Yet this unprecedented upswing occurred at a time when banks and other traditional lenders were themselves struggling with the impacts of the financial crisis (and, later, with the regulatory repercussions that significantly scaled back their ability to invest in distressed situations). Non-traditional lenders, such as investment funds – both private equity and hedge funds – stepped into the resulting funding gap. Unlike traditional banks, investment funds are subject to significantly less regulatory oversight and reporting obligations. This gives them significantly greater flexibility in their investment strategies which, in the economic downturn, meant that they had a greater appetite for and ability to invest in distressed situations.

In the decade since the onset of the financial crisis, investment funds have played diverse and varied roles in Chapter 11 cases. They invest in every level of a debtor's capital structure. They provide financing to fund the case and to fund operations post-emergence. They purchase assets through section 363 sale and Chapter 11 plan processes. They engage in constructive negotiations with debtors to implement fully consensual restructurings in record time. And they may stake out positions that require them to employ a full range of litigation tactics.

Of these myriad approaches, two overarching strategies stand out. First, investment funds are increasingly the primary financing source for distressed companies, providing debtor-in-possession (DIP) financing to fund Chapter 11 cases as well as exit financing to fund operations post-bankruptcy. Investing new capital in a distressed company in this manner can yield substantial returns for a fund over a relatively short period of time, since the interest, fees and premiums that are earned on such investments tend to be significant. Moreover, by providing such financing, funds gain substantial leverage and control over the company's direction.

In the context of DIP financing, for example, DIP lenders occupy the senior-most position over all other investors in the company and are first in line to be repaid. In this capacity, DIP lenders can exert considerable influence over a Chapter 11 case. Among other methods, DIP lenders typically impose milestones on debtors which set forth the key events that must transpire during the cases – such as the confirmation of a plan of reorganisation or the consummation of a section 363 sale process – and the time frame within which these events must occur. For institutions that are already invested in the company, this level of control and influence can be particularly attractive as a way to protect their existing investment. In fact, in many instances, DIP loans can be structured to improve existing investments.[1]

Second, investment funds increasingly invest throughout the capital structure of distressed companies. In many cases, the presence of well-heeled, sophisticated investment funds facilitates a quick and cost-efficient restructuring, avoiding a prolonged Chapter 11 case and the resulting administrative expenses – most notably, professional fees – and delay that can otherwise materially impair the company's ability to successfully reorganise and the fund's ultimate returns. As a consequence, there has been a noticeable increase in so-called 'pre-arranged' and 'pre-packaged' Chapter 11 cases.[2] In these instances, the terms of a Chapter 11 plan are fully negotiated before the case begins through agreement among the company and its key creditor constituencies – typically, one or more ad hoc groups of investors holding majorities of the company's funded indebtedness – including the group believed to hold the fulcrum security. The company then enters Chapter 11 to implement the negotiated deal in the shortest possible time frame.[3] Pre-packaged Chapter 11 cases can often be completed in 30-45 days, or sometimes even less. Indeed, the debtors in two recent pre-packaged Chapter 11 cases were able to obtain confirmation of their plans of reorganisation in less than a single day.[4]

On the opposite end of the spectrum, investment funds may choose to invest in more junior levels of a company's capital structure or seek to exploit what they perceive to be a flaw in the company's loan agreements or indentures. These more speculative investments are increasingly popular in slower restructuring markets – like today's market – where distressed investment opportunities are diminished and returns are harder to come by. Generally, realising a return on these types of more speculative investments often requires

1 One common example is known as a 'roll-up', where the new funds advanced as part of the DIP financing are used to repay pre-petition loans. See *In re Capmark Fin. Gp. Inc.*, 438 B.R. 471, 511 (Bankr. D. Del. 2010) ('Roll-ups most commonly arise where a pre-petition secured creditor is also providing a post-petition DIP loan ... The proceeds of the DIP loan are used to pay off or replace the pre-petition debt, resulting in a post-petition debt equal to the pre-petition debt plus any new money being lent to the debtor. As a result, the entirety of the pre-petition and post-petition debt enjoys the post-petition protection of section 364(c) and/or (d) as well as the terms of the DIP order.').

2 In 2003, only 6 per cent of large companies entered Chapter 11 with a pre-negotiated plan; in 2017, 42 per cent of all Chapter 11 filings by large companies (with assets of more than $500 million) were prepackaged. This has had a significant impact on the duration of Chapter 11 cases overall. For Chapter 11 cases confirmed in 2017, the median length of the case was only four months. See Norman Kinel, The Ever-Shrinking Chapter 11 Case, Nat'l L. Rev. (Aug. 20, 2018) (discussing 7 August 2018 report by Fitch Ratings).

3 In a 'pre-packaged' case (as compared to a 'pre-arranged' one), the parties have taken the additional step of soliciting votes on that plan before filing. In these instances, the company does not need to spend time in Chapter 11 engaged in solicitation; instead, the company moves straight to confirmation, ie, approval, of the plan.

4 See *In re Sungard Availability Services Capital, Inc.*, Case No. 19-22915 (RDD) [Dkt No. 46] (Bankr. S.D.N.Y. May 2, 2019); In re FullBeauty Brands Holdings Corp., Case No. 19-22185 (RDD) [Dkt No. 39] (Bankr. S.D.N.Y. Feb. 5, 2019).

funds to employ litigation tactics. These tactics can be aimed at proving an entitlement in relation to other creditors in the capital structure, or as leverage to obtain outsized recoveries as part of an overall settlement divorced from economic entitlement. While difficult to prove empirically, anecdotally, this practice increases the frequency of restructuring litigation and drives up the overall cost of a restructuring.[5]

What follows is a look at some of the more recent tactics employed by investment funds in large Chapter 11 cases.

Recent developments and trends: backstopped rights offering

A fertile ground for generating returns, particularly in recent years, is to offer to backstop new money investments, whether in the form of debt (eg, DIP and exit financing) or equity. The latter often takes the form of a rights offering, where existing investors are provided an opportunity to invest in the equity of a company about to emerge from Chapter 11, often at a discount (sometimes a substantial one) to the company's Chapter 11 plan value.

Rights offerings are attractive to companies in Chapter 11 that are otherwise capital constrained because they offer companies ready access to equity capital without substantial cost. This is due, in part, to the fact that many such offerings are exempt from registration with the SEC if certain requirements are met. Moreover, rights offerings are highly flexible financing structures that permit parties to customise both the terms and conditions of the equity issuance as well as the terms of the offering (including the allocation of the right to participate) to best serve the needs of the company or the specific circumstances of the company's Chapter 11 case. As a result, rights can be a valuable form of currency when negotiating creditor recoveries under a proposed plan. For these reasons, rights offerings are exceedingly popular: between January 2015 and December 2017, more than $5.5 billion was raised by distressed companies through rights offerings.[6]

In addition to providing a company with much-needed equity capital, rights offerings are very attractive to creditors, particularly in the relatively limited distressed investment market of the past few years where investment opportunities have been scarce. A key reason is that rights are usually offered at a significant discount to the assumed value of the reorganised company to encourage participation; while the exact percentage can vary widely from case to case, recent offerings typically use a discount of 20 to 25 per cent to plan value. That means investors can often acquire a more significant stake in the reorganised company at an implied 'in the money' valuation. These rights offerings further favour funds with capital to

5 But see Jared Ellias, *Are Litigious Hedge Funds a Problem? A Study of Activism*, 35 Am. Bankr. Inst. J. 28 (2016) (an empirical study of cases filed in the years immediately after the financial crisis that found that litigation commenced by funds who had invested in junior debt, so-called 'junior activism', was associated both with an increase in the assumed value of the restructuring transaction and higher recoveries than the market anticipated prior to the process).

6 Jay Goffman & George Howard, *Rights Offerings Prove Popular with Both Debtors, Distressed Investors*, J. of Corp. Renewal at *5 (Jan/Feb 2018).

invest, given the dilution that typically occurs through a rights offering.[7] Thus participation is critical to protecting plan recoveries, with those that participate benefitting at the expense of those that do not.

Investors can further enhance the investment opportunity afforded by a rights offering by agreeing to 'backstop' the offering, which means committing to purchase their pro rata shares along with any unsubscribed shares. This guarantee of the offering's success is of enormous value to the company. As such, acting as a backstop party can prove very lucrative. Backstop parties typically earn fees of between 3 and 7 per cent of the total offering in exchange for their commitments, which can be paid in cash or additional shares.[8] Backstop parties may also obtain a preferred, or over-allotment of rights to ensure a minimum participation above their pro rata allocation. In practice, these mechanisms provide backstop parties with enhanced economics that increase the return on their pre-existing investment in the company. These mechanisms also allow the backstop parties an opportunity to increase their ownership stake and, along with that, their voice in the governance of the reorganised company.

Given the substantial value at stake in a backstopped rights offering and the potential for overreach, these arrangements are often subject to challenge. Challenges are often levelled at the reasonableness of the backstop fees, though this can be difficult to establish since the market for these fees varies widely.[9] Other challenges take issue with the need and size of the preferred, or over-allotment of shares reserved for the backstop parties. Still other challenges have been made to the seemingly disparate treatment offered to the backstop parties as compared to similarly situated creditors in the same class.[10] Given the paucity of recent distressed investment opportunities in the US, the terms of such backstopped rights offerings increasingly generate litigation.

7 In one recent example, the court approved a plan under which the pre-petition noteholder class would receive their pro rata share of 79.5% of the equity in the reorganized debtors on account of their claims. That recovery, however, was subject to significant dilution by convertible notes that were being issued through a backstopped rights offering; upon conversion of the notes, the noteholders' 79.5% equity stake would be diluted down to 11.6% of the total equity. In re CHC Group Ltd., Case No. 16-31854 [Dkt No. 1794] (Bankr. N.D. Tex. March 3, 2017).

8 See Goffman & Howard, supra note 6.

9 For example, in the Pacific Drilling case, the court initially denied the debtors authorization to enter into an equity commitment agreement because it found the 8% backstop fee to be unnecessary to incentivize the commitment. In re Pac. Drilling S.A, Case No. 17-13193 [Dkt No. 622] (Bankr. S.D.N.Y. Sept. 27, 2018). The court ultimately approved a revised equity commitment agreement with a backstop fee of 8% for any unsubscribed portion of the rights offering and 5% for the rest, despite 'misgivings,' because all stakeholders supported the agreement. Id. [Dkt No. 616] (Sept. 25, 2018); Id. [Dkt. No. 634] (Oct. 1 ,2018).

10 Section 1123(a)(4) of the Bankruptcy Code requires that a Chapter 11 plan provide the same treatment for each class of claims or interests, unless a holder agrees to less favorable treatment.

In the *Peabody Energy* case, for example, the bankruptcy court confirmed a plan that contemplated:

- a $750 million backstopped rights offering of preferred equity to all eligible holders; and
- a $750 million private placement of such equity that was offered only to the backstop parties, over the objection of certain non-participating creditors who argued that the plan discriminated unfairly[11] against creditors that were not backstop parties.

The court found that the fees and premiums provided to the backstop parties – including the separate private placement as well as the allocation mechanisms therein – were permissible because they were not on account of the backstop parties' pre-petition debt holdings, but were in exchange for their post-petition backstop commitments. As such, section 1123 of the Bankruptcy Code was satisfied because all similarly situated creditors were treated equally because they were given the opportunity to participate in the rights offering.[12]

Furthermore, a recent decision in the *Breitburn Energy* bankruptcy case confirms that it is the opportunity to participate itself that is valuable and not the creditors' eventual recovery that matters.[13] In that case, the debtors' plan provided that the sole source of recovery for a particular class of creditors was the opportunity to participate in a $775 million rights offering; parties that elected not to participate would receive nothing. At confirmation, the court overruled the objection of a creditor who had chosen not to participate in the rights offering, and argued that it was not receiving a similar recovery as other similarly situated creditors who had chosen to participate. As part of a lengthy confirmation ruling, the bankruptcy court concluded that this plan treatment was permissible, because 'section 1123(a)(4) requires equality of treatment, not equality of result. It is satisfied if claimants in the same class have the same opportunity for recovery.'[14]

The creative structuring of backstop commitments and rights offering allocations that heavily favour the company's largest stakeholders – who are the parties most likely to provide a backstop commitment – is a trend that is likely to continue.

11 The objection also argued that the private placement violated the good faith requirement of section 1129(a)(3) because it failed to maximise the value of the Debtors' estate. The court held that the plan was proposed in good faith because the debtors mediated with their creditors to resolve a major dispute; the non-participating creditors received notice and could have intervened if they chose to do so; there was overwhelming consensus on the plan; and the debtors had considered alternative plans.

12 *In re Peabody Energy Corp.*, Case No. 16-42529 [Dkt No. 2763] (Bankr. E.D. Mo. March 30, 2017), aff'd, 933 F.3d 918 (8th Cir. Aug. 9, 2019); see also *In re CHC Group Ltd.*, Case No. 16-31854 [Dkt No. 1794] (Bankr. N.D. Tex. March 3, 2017) (confirming plan over objection of non-participating creditor, where plan provided the noteholder class with their pro rata share of 79.5% of the equity of the reorganized company, but recovery was subject to dilution down to 11.6% upon conversion of convertible notes being issued under a backstopped rights offering).

13 *In re Breitburn Energy Partners LP*, 582 B.R. 321, 358 (Bankr. S.D.N.Y. 2018).

14 Though the court denied confirmation of the plan for reasons unrelated to the rights offering in this decision, the plan was subsequently confirmed after the parties made certain technical modification. See *In re Breitburn Energy*, Case No. 16-11390 [Dkt. No. 2387] (Bankr. S.D.N.Y. March 26, 2018) (order confirming modified plan).

Recent developments and trends: eve-of-filing bankruptcy case financing

A variation on traditional DIP financing that may be an emerging trend involves a prospective debtor obtaining financing for the costs of its Chapter 11 case immediately before filing a bankruptcy petition. This strategy takes advantage of the relatively permissive covenant and collateral packages included in debt issuances in recent years, which may permit a borrower with unencumbered assets to incur 'priming' debt senior to its other pre-petition debt outside of a bankruptcy case, without obtaining the consent of existing creditors or resorting to the bankruptcy court's power to grant administrative expense status and superpriority liens. [15] Thus, the prospective debtor and the lenders providing the financing may be able to achieve many of the objectives of a traditional DIP financing – providing liquidity to the debtor and a substantial return and a measure of influence over the case to the lenders – without the need for court approval and the attendant cost, risk and potential concessions to other constituencies.

Two recent examples illustrate this innovative strategy. First, in March 2019, PHI, Inc obtained a $70 million loan from Blue Torch Capital LP and promptly filed for Chapter 11. The loan was secured by a first lien on certain previously unencumbered aircraft. PHI noted the benefits of the financing in 'allowing the Debtors to tell their employees and vendors that there was sufficient liquidity to run the business at the very beginning of [the bankruptcy case], thereby maintaining their confidence' and 'avoiding the administrative burden of seeking court approval to use the DIP financing, which would have interfered with daily operations of the Debtors.'[16]

Then, in May 2019, Bristow Group Inc entered into a $75 million term loan facility, together with a restructuring support agreement providing for an additional $75 million of post-petition DIP financing, with certain of its existing secured noteholders immediately before filing for Chapter 11. The loan was secured by certain of Bristow's previously unencumbered assets, including certain aircraft and 35 per cent of the equity interests in Bristow's foreign subsidiaries. Bristow touted the advantages of the term loan in, among other things, 'allow[ing] the Debtors to go into a Chapter 11 with an agreement for the use of cash collateral, and avoid the prospect of a first-day valuation dispute.'[17]

However, eve-of-filing financing arrangements may present potential risks when compared with traditional DIP financing. The PHI and Bristow financing arrangements were both sharply criticised by other stakeholder groups in the respective bankruptcy cases. The unsecured creditors' committee in PHI, suggested that PHI may have opted for pre-petition

15 Notably, owing to recent changes to US federal income tax law, US corporate debtors with significant foreign subsidiaries may have increased flexibility to pledge previously unencumbered equity in such subsidiaries as collateral for pre-petition bankruptcy case financing without the significant federal income tax costs that may have precluded such a pledge under prior law. See T.D. 9859, 84 Fed. Reg. 23716 (23 May 2019) (creating a regulatory exception to certain deemed dividend rules under the Internal Revenue Code of 1986, as amended, applicable to the provision of US credit support by controlled foreign corporations).

16 *In re PHI, Inc.*, Case No. 19-30923 [Dkt No. 506] (Bankr. N.D. Tex. 18 May 2019).

17 *In re Bristow Group Inc.*, Case No. 19-32713 [Dkt. No. 25] (Bankr. S.D. Tex. 12 May 2019).

financing to avoid having 'to bring a DIP financing proposal to the Court for approval' or to manufacture an impaired accepting class to permit a cramdown of unsecured creditors.[18] An ad hoc group of unsecured noteholders in Bristow threatened to litigate whether, among other things, Bristow and the secured noteholders acted in good faith in connection with the pre-petition financing and restructuring support agreement.[19] In addition, the absence of a court order approving an eve-of-filing financing leaves lenders exposed to the risk that their loans and liens would be avoided as a fraudulent conveyance, or that their liens may be improperly perfected.

Whether this nascent development will grow to become a widely utilised alternative to DIP financing remains to be seen.

Recent developments and trends: litigation trusts

The increasing use of bankruptcy litigation trusts that are formed under a Chapter 11 plan to pursue litigation post-bankruptcy has provided investment funds with an additional source of recovery and an opportunity to deploy capital.

By way of background, post-confirmation litigation trusts are commonly used when debtors have significant litigation claims against third parties, the resolution of which is not required for the company to emerge from Chapter 11. In these cases, the debtor will bequeath the right to pursue these claims to a newly formed litigation trust and will typically seed the trust with some amount of initial funding. Interests in the trust will then be distributed pro rata to particular creditor groups (typically, junior classes) as part or all of their recovery on account of their pre-petition claims. Those interests, which often are freely transferable, entitle the holders to receive their pro rata share of any value that is ultimately obtained through prosecution of these claims.

The preservation of causes of action through litigation trusts is increasingly popular. As one practitioner recently noted, 'It is now rare for a plan of reorganisation for a major bankruptcy to be confirmed without the inclusion of a litigation trust as a mechanism to allow the continuation of actions to recover for the creditors.'[20] In large part, this is because the creation of a litigation trust enables a debtor to emerge promptly from Chapter 11, notwithstanding one or more large unresolved litigation claims. Litigation trusts can also be advantageous for creditors that perceive value in the litigation claims and are willing to incur the risks and delays associated with litigation. Traditionally, junior creditors have been more likely to accept those risks in order to obtain a potentially larger overall recovery. Increasingly, however, investment funds have shown both a willingness to receive a stake in a litigation trust as part of their overall recovery under the plan and to finance the underlying litigation.

18 *In re PHI, Inc.*, Case No. 19-30923 [Dkt No. 506] (Bankr. N.D. Tex. 18 May 2019).

19 *In re Bristow Group Inc.*, Case No. 19-32713 [Dkt No. 53] (Bankr. S.D. Tex. 14 May 2019).

20 Jeffrey Pomerantz et al, Bankruptcy Litigation – Roundtable Discussion, *Financier Worldwide Mag.* (July 2016) (comments of Timothy Martin).

The *Paragon Offshore* bankruptcy cases provide an example.[21] There, the debtors possessed litigation claims against its former parent company, Noble Corporation, which represented a major potential source of recovery for creditors. Initially, the debtors had proposed a Chapter 11 plan premised on settling these claims. This plan eventually gave way to one that preserved those claims for creditors and placed them into a litigation trust. Notably, the interests in that litigation trust were granted not just to junior creditors of the company, but also to secured creditors. In fact, the trust interest proved to be a valuable medium through which to resolve disputes between the secured and unsecured creditors.[22]

The increasing use of litigation trusts in bankruptcy has afforded investment funds with other investment opportunities as well – specifically, in the area of financing. Typically, the debtors' plan will seed a litigation trust with an initial cash amount when it is formed, after which, the trust is responsible for its funding needs. Increasingly, however, parties have started to experiment with alternative funding structures, including funding from third parties.[23]

One recent case concerns a litigation trust that was established in the 2009 mega-bankruptcy filing of General Motors to prosecute certain avoidance actions relating to the company's pre-petition term loan. The initial funding for that trust proved insufficient given the size and scope of the litigation, which led the trust administrator to conduct a competitive marketing process to obtain additional funding. Through this process, the trust received two funding proposals: under the first, an investment fund proposed to loan US$15 million to the trust in exchange for up to 4.75 per cent of the eventual proceeds of the litigation; under the second, the company's DIP lenders proposed to loan US$15 million to the trust in exchange for 30 per cent of the eventual proceeds of the litigation as part of a larger settlement. The trust chose the second option, notwithstanding the apparently higher cost of the loan, because of the benefits to unsecured creditors resulting from the overall settlement.[24] This decision was approved by the bankruptcy court, and affirmed on appeal, over the objection of the proposed third party investor.[25]

21 *In re Paragon Offshore PLC*, Case No. 16-10383 (Bankr. D. Del. 2016).

22 The litigation trust subsequently commenced a $1.7 billion suit against the former parent company, which remains pending. *Paragon Litigation Trust v. Noble Corp. PLC et al.*, Case No. 17-51882 (Bankr. D. Del. 2017).

23 See generally Kenneth Epstein & Eric Fischer, *Litigation Funding in Bankruptcy Court: An Essential Tool for Maximizing the Value of the Debtor's Estate*, 259 N.Y.L.J. 50 (2018).

24 By fixing the DIP lenders' percentage recovery at 30 per cent, the settlement resolving a pending dispute between the DIP lenders and general unsecured creditors over their respective entitlements to the proceeds of this litigation. The bankruptcy court found that the terms of the settlement, including the negotiated 70 per cent recovery for unsecured creditors, was reasonable when compared to the cost and uncertainty of litigating this issue. In contrast, the third party loan did not resolve this dispute, which left the recovery for unsecured creditors unknown.

25 See *In re Motors Liquidation Co.*, 2017 WL 3491970, at *9 (S.D.N.Y. Aug. 14, 2017).

Recent developments and trends: debt default activism

Investment funds may also seek to generate returns by investing in a company's capital structure with the intention of exploiting perceived flaws in, or arguable breaches of, the company's credit documentation. Particularly when paired with the use of credit derivatives, this strategy has received a lot of attention recently and has led some market participants to develop innovative provisions to protect themselves.

The case of *Windstream Holdings Inc* is instructive. In October 2017, Aurelius Capital Master, Ltd directed the trustee under Windstream's senior unsecured notes to file suit against Windstream alleging that a transaction undertaken in 2015 violated certain covenants in the bond indenture – in other words, that Windstream had, unbeknownst to Windstream and its other investors, been in default under the indenture for more than two years. In February 2019, after a bench trial, the court ruled in favour of Aurelius and awarded a judgment of more than US$300 million,[26] prompting Windstream to file for bankruptcy shortly thereafter. Aurelius was reported to have profited from a position in credit-default swaps (CDS) that entitled Aurelius to payment if Windstream defaulted on its debt.[27]

The potential for CDS to create incentives for investment funds to assert debatable defaults, and to obstruct or refuse to participate in restructuring negotiations that might avoid a default, has prompted some companies to negotiate for novel protections in their credit documents. For example, in May 2019 and June 2019 respectively, Charter Communications and Grubhub each issued bonds under indentures that included a contractual 'statute of limitations' limiting the period during which bondholders can declare a default to two years after the underlying action is reported publicly or to bondholders.[28] And in June 2019, Sirius Computer Solutions issued bonds that prohibited holders who are 'net short' from voting on holder actions.[29] While these innovations, if widely adopted, may limit the type of debt default activism pursued in Windstream, opportunities to generate returns through creative and aggressive litigation tactics will undoubtedly persist.

26 *US Bank Nat'l Assoc. v Windstream Servs., LLC*, No. 17-CV-7857 (JMF), 2019 WL 948120 (S.D.N.Y. 15 February 2019).

27 See, eg, Mary Childs, Windstream Loses Legal Case Against Hedge Fund Aurelius, and Now Is Stuck With a Huge Bill, Barron's, 16 February 2019, http://www.barrons.com/articles/windstream-loses-legal-case-against-hedge-fund-aurelius-and-now-is-stuck-with-a-huge-bill-51550318739.

28 See https://www.sec.gov/Archives/edgar/data/1091667/000119312519161294/d753026dex42.htm

29 Mary Childs, Why Hedge Funds Could Find It Harder to Push Companies Into Default, Barron's, 2 August 2019, http://www.barrons.com/articles/hedge-funds-could-find-it-harder-to-push-companies-into-default-51564771477.

Conclusion

Investment funds continue to play a significant role in Chapter 11 cases. They are flexible, sophisticated investors who are able to adapt quickly to changing market conditions to find new ways to deploy capital and maximise their investments. In the most prominent of these recent trends, investment funds have found increasingly creative ways to achieve short-term gains through new investments in distressed companies while at the same time positioning themselves to obtain longer-term payoffs. In achieving these goals, investment funds adapt existing tactics and strategies to new situations and new aspects of Chapter 11 practice. The new developments discussed herein offer excellent examples of the creativity and flexibility that can mark investment fund activity in distressed situations.

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Sovereign Debt Restructuring: A Latin American Perspective

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In summary

This chapter addresses transactional aspects of sovereign debt restructuring and litigation issues when dealing with sovereign debt, emphasising previous crises from Latin America, such as Argentina, Ecuador, Jamaica, Peru, Venezuela – and particularly Uruguay as a benchmark on how to restructure sovereign debt.

Discussion points

- How to restructure sovereign debt
- The distinction between debt re-profiling and debt restructuring
- Different tools and techniques available to enhance creditor participation
- Issues of concern when suing a sovereign debtor
- Lessons learnt from previous debt restructurings in Latin America

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Forecasting the balance of payments for Latin American Countries has become a major indoor sport among bankers, bureaucrats, and academics.
Carlos F Diaz-Alejandro[1]

Introduction

Edward III of England borrowed money from certain Florentine banks to finance his war against France, which then defaulted in 1340, resulting in the bankruptcy of Peruzzi Bank (1343) and Compagnia dei Bardi (1346). In view of this, it has been said that a 'king's promise to repay could often be removed as easy as the lender's head'.[2]

In other words, being a creditor of a sovereign state is particularly difficult due to its nature. Sovereigns' acts can be considered acts of state and can enjoy sovereign immunity. If considered an act of state, such act would be shielded from external scrutiny by the laws of a foreign state. Sovereign immunity will shield the sovereign and its agents from jurisdiction. The mentioned example also shows that sovereign default and debt restructuring is no breaking news. Historically, debt accumulation by sovereigns has been a pressing issue. Sovereigns states tend to accumulate debt beyond reasonable control to unsustainable levels, consequently leading to an increased need for debt restructuring.[3]

With globalisation, sovereign debt has atomised and debt recovery has become more complex. This becomes even more evident considering that the public debt of 32 countries is currently unsustainable or at high risk of default.[4] This chapter will address transactional aspects of sovereign debt restructuring and litigation issues when dealing with sovereign debt. In doing this, particular emphasis will be put on previous crises episodes from the region, such as Argentina, Ecuador, Jamaica, Peru and Venezuela. Finally, the case of Uruguay is analysed in more detail as it can be seen as a benchmark on how to restructure sovereign debt.

Debt Reprofiling v Debt Restructuring and Substantial v Procedural Aspects

Accumulating debt beyond sustainable levels leads to complex economic crises. Even if the accumulated debt is within reasonable levels, economic crises can be triggered by endogenous or exogenous shocks or simply by correlated or uncorrelated liquidity problems with maturities in the short term. For example, even if one could argue that Argentina's current accumulated debt is within sustainable levels compared with other countries or based on its

1 Carlos F Diaz-Alejandro, 'Latin American Debt: I don't think we are in Kansas anymore', *Brookings Papers on Economic Activity*, 2, 1984, page 384.

2 Carmen Reinhart and Kenneth Rogoff, *This Time is different: Eight centuries of financial folly*, Princeton University Press, 2009, page 69.

3 See International Monetary Fund, Proposals for a Sovereign Debt Restructuring Mechanism (SDRM): A Factsheet, January 2003, available at <http://www.imf.org/external/np/exr/facts/sdrm.htm>.

4 Paul Callan, Bassem Bendary and Yohann Sequeira, 'Emerging markets face a new debt crisis: Chinese lending is not the only cause', *Financial Times*, 13 March 2019.

debt-to-GDP ratio, the Argentine government has to upfront maturities in foreign currency of approximately US$15 billon until 2021, creating significant liquidity problems due to current political uncertainty.

To prevent these economic crises, sovereign states may conduct debt management programmes that can result in a debt re-profiling or restructuring. If done pre-emptively, it is referred as a debt re-profiling (a voluntarily exchange offer prior to default) or once the default has already occurred, it is referred as a debt restructuring. In other words, the main difference between a debt re-profiling and a debt restructuring is the timing when the exchange offer or debt management exercise is performed. A debt re-profiling can help ease the pressure of an internal devaluation by reducing the debt servicing burden. Jamaica is an excellent example, where interest costs and principal repayments exceeded the countries revenues. Through a voluntarily domestic debt exchange offer performed in early 2010, and without entering into default, Jamaica released some of its servicing debt burden. Examples of debt re-profiling on external debt also include Uruguay in 2003 (or more recently Greece in 2012). In the case of Greece, it was done using collective action clauses (CACs).

Since most of sovereign debt is documented by means of bonds (either domestic or international), sovereign debt restructurings are usually complex processes. Broadly speaking, sovereign debt restructuring can be understood as the technique used by sovereign states to prevent or resolve financial and economic crises and to achieve debt sustainability levels.[5] Any debt restructuring has two aspects: procedural and substantial. The focus is on the procedural aspects (ie, the way to conduct a restructuring and the techniques or tools that can be used to enhance the degree of participation). The substantial aspect, on the contrary, involves the actual restructuring of debt which can be achieved by rescheduling amortisation schedules and the possibility of reducing interest rates and principal.

Sovereign debt restructuring

With many banks and retail bondholders now involved, private creditors have become increasingly numerous, anonymous and difficult to coordinate. The goal of debt restructuring should be a better and more timely handling of unsustainable sovereign debts, while at the same time protecting asset value and creditors' rights.[6]

Sovereign debt restructurings are generally conducted through the use of voluntary exchange offers or CACs. The former can involve the use of other legal techniques, such as contractual 'sweeteners' to enhance the degree of participation of creditors or 'exit consents' to compel creditors to participate. The latter (ie, CACs) are clauses that most of the time are

5 Most of sovereign debt is documented by means of bonds issuances (either domestic or international). Multilateral debt is at best rolled over and Bilateral is usually rescheduled or restructured under the aegis of the Paris Club.

6 Anne Krueger, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, Address at the National Economists' Club Annual Members' Dinner American Enterprise Institute (26 November 2001), available at http://www.imf.org/external/np/speeches/2001/112601.htm.

included in the prospectus of a bond issuance, requiring the interaction of bondholders to perform an action aimed at facilitating the restructuring of these debt instruments by overcoming coordination issues.

The sweeteners can be seen as an ad hoc contractual tool to address the lack of a formal regime and to enhance the degree of participation of creditors. Some examples of these contractual sweeteners include mandatory prepayment clauses or mandatory restatement of principle clauses. These are clauses that you can include in the new terms of the bonds when you launch the exchange offer to try to convince your creditors that they are still going to be protected, either by reducing the outstanding stock of debt (ie, mandatory prepayment clauses) or that the accepted face value reduction will be reinstated in the event of a new event of default. These were used by Ecuador in the year 2000.

Other creditor participation-enhancing techniques include:

- the use of credit-linked notes (eg, as in Argentina 2005 and Greece 2012);
- a guarantee (eg, as in Seychelles in 2010 where a guarantee was provided by the African Development Bank);
- the use of a principal defeasance (eg, as it was considered in an early stage of the Greek private sector involvement); or
- the use of collateral (eg, as in the Brady Plan).

Another option is the 'most favoured creditor clause' (MFCC), usually linked to another clause known as the Rights Upon Future Offers clause, as used by Argentina in 2005 which was at the epicentre of the pari passu litigation in New York.[7] If a sovereign decides to enter into a repurchase, a new exchange offer or an offer to purchase of exchange, or enter into a settlement in better terms than the offer made to the original bondholders at the time of the exchange offer, due to the MFCC included in the new terms of the bond being issued as a result of the exchange offer, the 'more beneficial' terms being offered will also be extended to those that accepted to enter into the exchange offer.

In separate subsections below, the use and features of CACs are analysed, as well as the exit consent technique to enhance the degree of participation in an exchange offer.

Collective action clauses

Collective action clauses are generally included in the prospectus of a bond issuance that can be categorised[8] in:

- collective representation clauses intended to coordinate representation of the bondholders as a group;
- majority action clauses as an action to be taken or adopted by a majority decision;
- sharing clauses, which provide that any proceeds obtained from the debtor would be shared among all the creditors on a pro rata basis; and

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7 *NML Capital, Ltd. v Republic of Argentina*, 12-105(L).

8 See Liz Dixon and David Wall, Collection Action Problems and Collective Action Clauses, Financial Stability Review, June 2000.

- acceleration clauses that require voting on bonds to accelerate unmatured principal in the event of a default.

In the context of sovereign debt, the term collective action clauses have been indistinctively used to describe majority action clauses or, in other words, clauses that provide contractual cramdowns by enabling a qualified majority to bind a minority to a change in the terms of the bonds. CACs are important because a willing majority can force a dissenting minority to accept a face value or interest reduction, or an extension of maturity, creating a more orderly and predictable restructuring process.

The required majority threshold to amend the terms of the bonds containing CACs has generally been 75 per cent in aggregate principal amount of the outstanding bonds. However, the first CACs were included on single bond issuances only, allowing modifications series by series. This creates a problem in itself because bonds had to be restructured series by series and could lend to different outcomes depending on each series. As explained by Billington, each class of bondholders 'will be reluctant to "go first" without any guarantee that the holders in the other classes will provide similar relief'[9] – a classic prisoner's dilemma problem. This was addressed by the adoption of an aggregation feature, binding all creditors (including dissenting series) if the modification is approved by the pre-established supermajority across all series. The current industry standard (proposed by the International Capital Market Association (ICMA) in 2014 and then endorsed by the International Monetary Fund)[10] requires a supermajority of 75 per cent of the total aggregate number of bondholders to allow cross-series modification, disregarding the individual voting results of each class or series.

Exit consents

Exit consent is the technique by which holders of bonds in default who, deciding to accept an exchange offer, at the moment of accepting said offer, grant their consent to amend certain terms of the bonds that are being exchanged. By using the exit consent technique, the exchange offer is conditioned to a minimum threshold of creditors' acceptance and the amendments to the terms are performed once the required majority has been obtained. By means of these amendments, the defaulted bonds subject to the exchange offer become less attractive (in legal and financial terms), forcing a greater number of bondholders to accept the exchange offer. Otherwise, if holdout bondholders do not accept the exchange offer, they will be holding an impaired bond not featuring some of the original contractual enhancements. It is important to stress that this technique is used in conjunction with a voluntary exchange offer.

In the absence of CACs, the terms and conditions usually required to amend a sovereign bond issued under New York law are:

9 David Billington, 'European Collective Action Clauses', in R. Lastra and L. Buchheit, *Sovereign Debt Management* (eds.), OUP, 2014, page 409.

10 See IMF, Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring, October 2014.

- a 51 per cent nominal value quorum in the first meeting or a 25 per cent quorum on any subsequent adjourned meeting; and
- 662–3 per cent of the nominal value of the series to amend any other than payment term.

Under English law, amendments require:
- simple majority of the nominal value of each series to adopt resolutions; and
- the quorum required to amend any other terms will be two or more persons holding or representing not less than 50 per cent of the nominal value of the series.

Ecuador used exit consents to modify certain non-payment terms in order to make old bonds less attractive in its restructuring in 2000. The participation in the proposed exchange offer implied voting in favour of a list of amendments to the non-payment terms,[11] including:
- the requirement that all payment defaults must be cleared as a condition for any rescission of acceleration;
- the provision restricting Ecuador from purchasing any of the Brady bonds while a payment default is continuing;
- the covenant prohibiting Ecuador from seeking a further restructuring of Brady bonds;
- the cross-default clause;
- the negative pledge covenant; and
- the covenant to maintain the listing of the defaulted instruments on the Luxembourg stock exchange.[12]

Ecuador also made some additional commitments to enhance the exchange offer (ie, the sweeteners previously mentioned), including:
- mandatory prepayment arrangement after 11 and six years for the 2030 and 2012 bonds, to provide liquidity to investors[13] and to reduce the debt to a sustainable size; and
- mandatory 'reinstatement' of principal clause, which obliged Ecuador to issue additional bonds in the same amount of the debt reduction obtained through the exchange offer in the event that an interest default occurs during the first 10 years of the new issuance to discourage casual defaults on the new bonds by giving the government an incentive to make payments.[14]

In the end, 97 per cent of its bondholders agreed to participate in Ecuador's exchange offer.[15]

11 Michael Chamberlain, 'At the Frontier of Exit Consents' at the Bear Stearns & ECMA Sovereign Creditors Rights Conference (November 2001).

12 Anne Krueger, *International Financial Architecture for 2002: A new approach to sovereign debt restructuring* (November 2001).

13 Hal S Scott and Philip A Wellons.

14 IMF, IMF Board Discuss Possible Features of a Sovereign Debt Restructuring Mechanism (January 2003).

15 Ibid.

Sovereign debt litigation

In the context of a sovereign restructuring, why would a creditor accept an exchange offer for much less favourable terms? Any creditor, before rejecting an exchange offer (or even before the use of CACs is attempted) has to analyse its legal options. Certain useful questions to consider in this analysis are: can a sovereign be sued? Where can a sovereign de sued? Does the state enjoy sovereign immunity? Finally, and most importantly, if successful, how can a judgment against a sovereign be enforced?

Can a sovereign be sued? (act of state)

The act of state doctrine precludes the courts from inquiring into the validity of the public acts of a recognized foreign sovereign power which have been committed within its own territory[16]. The application of the act of state doctrine necessitates a case by case analysis. This is based on the sensitivity of foreign policy given the legal and political issues[17] involved. Generally, there are two prerequisites: that the sovereign's action is taken within its own territory and that the application takes place within the sovereign's own territory.[18] Typically, illegality of a sovereign's act under its own law does not prevent application of the act of state doctrine.[19]

In *Alfred Dunhill of London Inc v Republic of Cuba*, the US Supreme Court held that for purely commercial acts, sovereigns would not be afforded act of state doctrine protection.[20] Consequently, the act of state doctrine will rarely prevent courts from inquiring into the validity of a sovereign's attempts to force refinancing of its obligations to sovereign bondholders. In *Libra Bank Ltd v Banco Nacional de Costa Rica*, the New York federal appeals court considered whether the act of state doctrine required recognition of a Costa Rican Central Bank resolution restraining external payments in foreign currencies and thus whether

16 See *Underhill v Hernandez*, 168 U.S. 250, 252, 18 S.Ct. 83, 42 L.Ed. 456 (1897); *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 401, 84 S.Ct. 923, 11 L.Ed.2d 804 (1964); *M. Salimoff & Co. v. Standard Oil Co. of New York*, 186 N.E. 679 N.Y.,1933; *Frazier v. Foreign Bondholders Protective Council, Inc.*, 125 N.Y.S.2d 900 N.Y.A.D. 1 Dept.,1953; *Holzer v. Deutsche Reichsbahn-Gesellschaft*, 14 N.E.2d 798 N.Y.,1938.

17 The US Supreme Court argued in the Sabbatino that: 'If the act of state doctrine is a principle of decision binding on federal and state courts alike but compelled by neither international law nor the Constitution, its continuing vitality depends on its capacity to reflect the proper distribution of functions between the judicial and political branches of the Government on matters bearing upon foreign affairs . . . . It is also evident that some aspects of international law touch much more sharply on national nerves than do others; the less important the implications of an issue are for our foreign relations, the weaker the justification for exclusivity in the political branches'. *Banco Nacional de Cuba v Sabbatino*, 376 U.S. 398, 401, 84 S.Ct. 923, 11 L.Ed.2d 804 (1964)

18 See Restatement (Second) Foreign Relations Law of the United States § 41 (1965).

19 See *Banco de España v Federal Reserve Bank of New York*, 114 F.2d 438, C.A.2 1940

20 425 US 682 (1976).

the resolution would protect a Costa Rican bank subject to an action to collect brought by an English corporation as Agent for 16 banks.[21] The appeals court rejected the act of state doctrine defence, holding that the situs of the debt owed was the US, given that

- Banco Nacional had consented to jurisdiction in New York;
- the loan agreement was construed under New York law;
- payments were due at a New York bank; and
- Banco Nacional had US$2.5 million in various New York bank accounts at the time the resolutions were entered.[22]

In the UK, the position with respect to the act of state doctrine is similar to the US. Fox notes that the main difference is that in the UK the act of state doctrine operates as a defence to litigation, while in the US, it operates as a defence but may also be used as a 'basis for a substantive remedy'.[23]

Where can a sovereign be sued?

Another aspect to analyse is which applicable law and jurisdiction governs the bonds that the creditor holds. As mentioned before, when a sovereign's accumulated debt reaches unsustainable levels, economic crises strikes in and any government's first reaction could be declaring the 'economic emergency' through a law or an executive order, just like happened in Argentina in 2001. Economic crises affecting emerging markets usually impact deeply in society, especially in the most vulnerable classes. In this scenario, emergency laws tend to restrict the possibility of domestic enforcement against a sovereign. Therefore, bonds (Eurobonds or Global Bonds) are usually governed by foreign law and they submit to one or more foreign jurisdictions. Therefore, in order to escape sovereign interference, avoid the domestic courts. Foreign courts will not let domestic laws interfere with a foreign law governed bond.

Does the state enjoy sovereign immunity? (sovereign immunity)

Even under New York and English law and jurisdiction, it is important to understand if the debtor will be entitled to claim immunity from suit or execution.

Sovereign immunity is a legal doctrine that has its origin in the ancient English principle that the monarch can do no wrong and, by which, a sovereign is immune from civil proceedings or criminal prosecution. In 2012, NML Capital filed an attachment request before the courts of Ghana for an Argentine army ship (*Fragata Libertad*) in a desperate attempt to recover unpaid debt from Argentina. In short, the International Tribunal for the Law of the Sea ordered the local courts of Ghana to release the ship, arguing that the ship was a military asset and, thus, that it benefited from sovereign immunity.

21 *Libra Bank Ltd. v Banco Nacional de Costa Rica* 570 F. Supp. 870 (SDNY 1981); *Libra Bank Ltd. v Banco Nacional de Costa Rica*, 676 F.2d 47, C.A.2 (N.Y.) (1983).

22 570 F.Supp. 870, 881-882.

23 Hazel Fox, *The Law of State Immunity*, Oxford University Press, 2002, p. 484. (OUP Oxford 2002). Also see *Banco Nacional de Cuba v Sabbatino*, 376 U.S. 398.

In the US, sovereign immunity is determined principally by the Foreign Sovereign Immunity Act 1976. In the UK, the international law principle of sovereign immunity is determined principally by the State Immunity Act 1978. Both pieces of legislation broadly grant sovereign immunity to sovereigns unless they are acting in a commercial capacity. In a 1992 US Supreme Court case concerning the Republic of Argentina, it was confirmed that the commercial activity exemption applies when the state issues sovereign debt (eg, a Eurobond), as it is a commercial activity.[24]

Although there is no doubt that issuing bonds in the international capital markets by a sovereign is considered a commercial activity (and therefore not subject to sovereign immunity), it is common practice that the governing law and jurisdiction clause in an issuance of debt instruments is complemented with a waiver of sovereign immunity to avoid any possible misinterpretation.

Enforcement

Even if immunity is waived by the sovereign, another problem remains. If a creditor chooses to sue the sovereign debtor, after obtaining a favourable judgment, it will still have to enforce such judgment. The only mechanism to enforce this judgment if the sovereign does not honour the court ruling is by executing property.

The problem is that sovereigns usually do not have many sizeable assets located abroad. Many assets have diplomatic immunity, immunity as result of being military in nature (eg, the *Fragata Libertad*) or assets that belong to an instrumentality of the government excluded from the scope of the waiver.

For example, in *EM Ltd v Banco Central de la República Argentina*, the US Court of Appeals for the Second Circuit refused to enforce a claim for US$2.4 billion against Argentina by collecting funds held by the Argentine Central Bank in New York. Although Argentina waived its sovereign immunity under the disputed bonds, the Second Circuit District Court found that the waiver did not include the assets of the Argentine Central Bank. Since the bank was an agency (instrumentality) of the sovereign state, it was immune from suit under the Foreign Sovereign Immunities Act.[25]

However, more recently, a federal judge in the state of Delaware determined that an instrumentality of the Bolivarian Republic of Venezuela, the state-owned oil company PDVSA, was an alter ego of Venezuela and, as such, its assets in the United States were attachable as assets of Venezuela.[26]

24 *Republic of Argentina v. Weltover Inc.*, 504 U.S. 607 (1992).

25 'Second Circuit determines that Argentine central bank is not alter ego of Argentina' Jeanna Rickards Koski, Caplin & Drysdale, 2016.

26 Nos. 18-2797 & 18-3124, Slip Op., (3d Cir. July 29, 2019).

Case study: Lessons for the Latin American region

Having addressed the main aspects related to the transactional nature of sovereign debt restructuring and having also analysed he potential risks in a litigation context, this section will analyse Uruguay's debt re-profiling. This has been Latin America's most successful restructuring case owing to the fact that it prevented a default, the high degree of creditor participation, how quickly it was performed, the betterment of the contractual documents and other factors. The main purpose in presenting this case study is to draw lessons that can be used throughout the region.

Uruguay (2003): A story of success

During 2002, Uruguay's economy was heavily impacted by the 2001 Argentine crisis. As explained by Buchheit and Pam, Uruguay decided to pre-emptively attack the liquidity problem before the situation would deteriorate into a default.[27] Uruguay's restructuring has been described by Beattie[28] as one that is almost straight out of the US Treasury Wall Street Rulebook of 'voluntary market-based' solutions, even if, in the end, the value of the bonds reached default levels.

Uruguay's total outstanding amount of debt was approximately US$5.3 billion, composed by 19 series of international bonds subject to English and New York law and was denominated in US dollars, euros, yen, British pounds and Chilean pesos.[29] Approximately, 50 per cent of the outstanding debt was held by retail investors and the same percentage was held by domestic investors.

Uruguay's exchange offer avoided default by obtaining the desired maturity stretching a complex but rapid re-profiling. The exchange offer was announced on 10 April 2003 and was completed on 29 May 2003, resulting in a successful restructuring with a bondholders' acceptance of 93 per cent. In 2003, after the debt exchange, the economy resumed growth with a 2.5 per cent rise in GDP.

The substantial aspect of Uruguay restructuring consisted in a debt re-profiling, in which Uruguay offered the bondholders to exchange the bonds for the 'Bonos Extensión', which was a new bond in the same currency of origin, bearing the same interest rate, with a five-year deferral on the original maturity date of the old bond, and the 'Bonos Liquidez', which offered greater liquidity than the old bonds since they were expected to be traded in the secondary debt market and they would provide a benchmark for future issues.[30]

27 Lee C. Bucbheit and Jeremiah S. Pam, 'Uruguay's Innovations' [2004] J.I.B.L.R. 28.

28 See Alan Beattie, 'Uruguay Provides Test Case for Merits of Voluntary Debt Exchange', *Financial Times*, 23 April 2003.

29 Lee C. Bucbheit and Jeremiah S. Pam, 'Uruguay's Innovations' [2004] J.I.B.L.R. 28.

30 For a detailed description on the 18 series issued see the Central Bank of Uruguay's webpage available at http://www.bcu.gub.uy/autoriza/sgoioi/reperfilamiento/seriesnuevasint.htm.

In separate but cross-conditioned transactions, Uruguay requested holders of yen-denominated bonds (Samurai bond), which contained a CAC, to amend its payment terms to extend the maturity date.[31] The CACs were successfully used to extend the maturity from 2006 to 2011 and to raise the interest rate from 2.2 per cent to 2.5 per cent.[32]

Uruguay's exchange offer is a good textbook example, not only because it was successful but also because it included several innovative legal techniques,[33] such as:

- 'check the box' exit consents;
- amendment of the waiver of immunity clause;
- incorporation of CACs in all the new bonds;
- aggregation;
- vote packing;
- disenfranchisement; and
- a prohibition of the use of exit consents coactively.

'Check the box' exit consents

As opposed to the Ecuadorian case in the year 2000 that used a coercive exit consent, the use of exit consents in the case of Uruguay was consensual. This means that creditors were able to choose if they want to grant their exit consents besides accepting the commercial terms of the offer. The way by which creditors gave their consent to the use of exit consents was by the sole fact of ticking a box, thereby it was referred as the 'check the box' exit consents. The use of exit consents by this innovative way of getting the consent of creditors was widely accepted in all the series, except in one where it was rejected by 13 per cent of its holders.

Amend the waiver of immunity

Uruguay sought the consent of the bondholders to amend three clauses of the old bonds to:

- remove the cross-default clause;
- delist the bonds that require to be listed on a stock exchange; and
- amend the waiver immunity clause.

In the case of Uruguay, it was the first time that the waiver immunity clause was amended. The remaining two were also amended in the 2000 Ecuador restructuring. The aim in amending this clause was to reinstate the immunity under English and New York law, respectively. The rationale behind this was to avoid the seizure of interest payments by creditors that do not participated in the restructuring as it happened to Peru's Brady bonds in the *Elliott Associates LP* case.[34]

31 Puhan Chunam and Federico Sturzenegger, *Default Episodes in the 1980s and 1990s, What have we learned?*; and Cleary, Gotlieb, Stean and Hamilton, 'Uruguay in Groundbreaking $5.2 Billion Debt Restructuring', May 29, 2003, available at http://www.cgsh.com/.

32 Ibid.

33 Ibid. Lee C. Bucbheit and Jeremiah S. Pam, 'Uruguay's Innovations' [2004] J.I.B.L.R. 28.

34 Elliott Assocs. L.P. General Docket No. 2000/QR/92 (Courts of Appeal of Brussels, 2000).

Incorporation of CACs in all the new bonds

Uruguay included CACs in all its new bonds resulting from the exchange offer. This meant that in the hypothetical case that Uruguay needed to restructure again its bonds, any term of the bonds could be amended with the consent of holders of 75 per cent of the aggregate principal amount of each series. It is worth mentioning that Uruguay bonds were subject to New York law. Uruguay followed the proposed CAC by the G10 working group in 2002. This model class has been superseded by the ICMA 2014 single-limb CAC, endorsed by the IMF.

Aggregation

By the aggregation mechanism, amendments to any terms (including payment terms) can be incorporated to one or more series of bonds simultaneously. In order to approve the amendment, a double majority is required:

- 85 per cent of the aggregate principal amount of all affected series; and
- 66.66 per cent of each specific series.

In the current industry model CAC (ICMA's 2014 single limb CAC), this has been simplified by removing the double threshold and reducing the supermajority to 75 per cent.

Vote packing

Uruguay agreed not to issue new debt securities or reopen any existing series of debt securities with the intention of placing such debt securities with holders that were expected to support any modification proposed by Uruguay.[35] The aim was to avoid new bonds being placed in the hands of investors that would vote in favour of a proposed amendment, thereby diluting the bondholders' holding.

Disenfranchisement

By disenfranchising bonds owned or controlled by Uruguay or any public sector instrumentally of Uruguay, such bonds are to be disregarded in a vote on a modification to the terms of the new bonds. Prior to any vote, Uruguay shall deliver to the trustee a certificate signed by an authorised representative of Uruguay, specifying any debt securities that are owned or controlled by Uruguay or any public sector instrumentality.[36] This has become an important issue on sovereign debt restructuring as result of Ecuador's behaviour in 2009.

35 Prospectus of the Republica Oriental del Uruguay, filed with the SEC pursuant to Rule 424 (b) (3) on 15 April 2003 and 9 May 2003, S-39 o S-41.

36 Ibid. 'Public sector instrumentality' means Banco Central, any department, ministry or agency of the government of Uruguay or any corporation, trust, financial institution or other entity owned or controlled by the government of Uruguay or any of the foregoing, and 'control' means the power, directly or indirectly, through the ownership of voting securities or other ownership interests or otherwise, to direct the management of or elect or appoint a majority of the board of directors or other persons performing similar functions in lieu of, or in addition to, the board of directors of a corporation, trust, financial institution or other entity.

On that occasion, Ecuador allegedly performed an aggressive secondary market repurchase via intermediaries when the price for the defaulted 2012 and 2030 bonds hit rock-bottom. Then, when a voluntary exchange offer was completed, the degree of participation was very high because Ecuador did not disenfranchise the bonds allegedly held by the government itself (or someone under its control). Estimates in the case of Ecuador placed the holding at 50 per cent of all outstanding series, therefore having a great impact on the exchange outcome.

Prohibition of the use of exit consents coactively

To avoid the use of exit consents in future potential restructurings in a coercive way, the terms of the bonds required that any modifications to the payment terms of the bonds proposed in the context of a future exchange offer cannot make the terms of that exchange offer less favourable that the current terms.

Conclusion

Successfully completed exchange offers (eg, Ecuador 2000, Uruguay 2003, Argentina 2005-2010, Belize 2006, Jamaica 2010) can be used to argue that the use of decentralised market-oriented techniques work (ie, CACs, exchange offers and the use of exit consents). These different countries have been selected because they serve as an ample sample of different types of restructuring episodes, including a pre-emptive debt re-profiling, default (with and without nominal value reductions) and the use of CACs and exit consents. In all these cases, the degree of participation in the exchange offer (ie, the rate of acceptance) has been above 90 per cent (Ecuador 97 per cent Uruguay 93 per cent, Argentina 93 per cent after two rounds of exchanges, Belize 97 per cent and Jamaica 99 per cent).

Despite the fact that none of these exchange offers achieved 100 per cent, it can be claimed they have been successful due to the high degree of participation, in all of them being well above 90 per cent. This is the result of contractual creativity in a scenario where the lack of an insolvency regime shapes the debtor–creditor dynamics.

As evidence demonstrates, episodes of sovereign bond restructuring have been resolved quickly, without severe creditor coordination problems and involving little litigation – the only significant exception being Argentina, a 'serial defaulter' and a 'rogue debtor'. So why try to mend something that is not broken?

The ad hoc market-centred voluntary approach of exchange offers should be endorsed. If CACs are already included in the debt instruments, they can simply be amended by the required contractual majority. However, it can benefit from complementary contractual sweeteners (to entice creditors to participate) and the use – if required – of exit consents (to increase the degree of participation of those creditors that were not convinced by the contractual sweeteners).

Although it is fairly straightforward to obtain a favourable judgment, enforcing it is completely different. Although the litigator's imagination has no boundaries, a sovereign usually does not have many attachable assets abroad. Even those few assets that are located abroad (ie, diplomatic missions, central bank reserves, payments to and from international financial institutions (eg, IMF), military assets), usually enjoy certain type of immunity.

Therefore, unless there are certain exceptional circumstances, a bondholder of a sovereign state should be better off participating in a restructuring arrangement where it can have certain leverage as a group.

Finally, sovereign debt restructuring often has political dimensions, including the need for additional financing in order to keep the economy running. As Gelpern has clearly stated, 'it is impossible to separate politics and finance in sovereign workouts'.[37]

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37 Anna Gelpern, 'What Iraq and Argentina Might Learn from Each Other', *Chicago Journal of International Law*, Vol 6, No. 1, 2005, page 414.

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