NORTON ROSE FULBRIGHT

International Restructuring Newswire

A quarterly newsletter from the global restructuring team at Norton Rose Fulbright

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International Restructuring Newswire

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To our clients and friends:

Welcome to our latest issue of the *International Restructuring Newswire*.

While the US economy continues to appear strong, some cracks emerged in the first quarter of 2023, with stresses in the banking sector requiring government intervention. The banking sector may not be out of the woods just yet. A recently published academic paper warned that 186 banks "are at a potential risk of impairment " because of "asset exposure to a recent rise in interest rates." In addition to bank jitters, there is also another sector in the US creating quite a bit of concern—commercial real estate. Work from home, layoffs, rising interest rates and mortgage refinancings coming due are taking their toll. Restructuring professionals can anticipate busy times ahead.

Uncertain economic conditions are, of course, not confined to the US. Global concerns remain with ongoing inflation, war in Ukraine and slowing economic growth. With Norton Rose Fulbright's global focus, in this issue we provide our restructuring insights on numerous jurisdictions and particularly on cross-border insolvency issues. Our restructuring lawyers based in the US, the UK, Australia, Canada and Hong Kong all have articles in this issue dealing with topics essential to the global restructuring community.

Good reading,

Howard Seife
Global Co-Head of Restructuring
New York

Scott Atkins
Global Co-Head of Restructuring
Sydney

In the news

Construction Law Webinar

February 2, 2023
Jason Boland participated in a webinar hosted by NRF's construction law team. He was joined by real estate partner, David Barksdale, where they discussed the looming potential for recession-caused troubled projects and assets and how to guard against and mitigate such problems.

INSOL International and ABI (Dubai) Seminar

January 17, 2023
Scott Atkins provided the opening address at the Dubai Seminar jointly hosted by INSOL International and the American Bankruptcy Institute. This event was a full day in-person program featuring expert panellists and keynote speakers, exploring the advancement of restructuring processes in the UAE and opportunities to build a stronger rescue and alternative finance market.

California CLE Blitz

January 25, 2023
Ryan Manns and **Rebecca Winthrop** presented on "What every in-house counsel needs to know about bankruptcy risk" at the California CLE blitz virtual program.

INSOL International New Delhi Seminar

February 3, 2023
Scott Atkins provided welcome remarks at the INSOL International India Seminar in New Delhi. This full day in-person event featured expert speakers who explored the evolution of India's corporate rescue regime, the regulation of insolvency practitioners in India and the potential to use ADR and asset tracing to enhance the efficiency of restructuring outcomes.

Insolvency Law Academy in New Delhi

February 4-5, 2023
Scott Atkins provided a special address at the Inaugural Conference of the Insolvency Law Academy in New Delhi. The Conference featured a series of panel sessions involving academics, judges and practitioners, with the aim of advancing the restructuring and insolvency ecosystem in India, including through stronger restructuring frameworks and the adoption of the UNCITRAL Model Law on Cross-Border Insolvency.

INSOL International Latin America Seminar

March 2-3, 2022
Howard Seife is chair of INSOL International's Latin America Committee and led the full-day in-person program in Rio de Janeiro, an event jointly hosted with the Turnaround Management Association. **Scott Atkins** provided welcome remarks at the seminar which focused on measures for strengthening insolvency processes in emerging markets in Latin America. **Andrew Rosenblatt** spoke on a panel discussing restructuring and collaboration across Latin America.

Scott Atkins also provided opening remarks at the Latin America Round Table jointly organised by INSOL and the World Bank. This event featured a combination of judges, regulators, practitioners and academics, the outputs of which will be used to advance law and policy reform discussions on improved restructuring and insolvency measures in Latin America to support financial stability and growth in the region.

Turnaround Management Association (TMA)

March 22 and March 16, 2023
Laura Johns provided welcome remarks at the TMA Sydney New Year Social hosted at our offices in Sydney. **Jenna Scott** also hosted the TMA at our offices in Brisbane for a panel session to discuss the importance of identifying the right turnaround team and the art of stakeholder engagement.

INSOL International Africa Judicial Colloquium

March 29, 2023
Scott Atkins delivered welcoming remarks at the Africa Judicial Colloquium. This was the latest in a series of Judicial Colloquia organised by INSOL International, in partnership with the World Bank, since 1995. The Colloquia are attended by judges, judicial administrators and representatives from legal and judicial ministries, and have had enormous success in promoting open discussion and collaboration between judicial officials across different countries and regions.

INSOL International and World Bank Group Africa Round Table

March 30, 2023
Scott Atkins provided the opening address at the INSOL International and World Bank Group Africa Round Table in Kigali, Rwanda. Joined by over 170 practitioners, judges and policy makers - including the Minister of Justice of Namibia Yvonne Dausab, the African Round Table helps to elevate insolvency reform on the African policy agenda, and promotes collaboration and engagement across the entire regional insolvency ecosystem.

Corporate Restructuring Executive Education

March 2023
Prof. Omar Salah was teaching the Legal Primer courses of the Corporate Restructuring Executive Education of the Dutch Restructuring Association in March 2023. The programme takes a corporate perspective on corporate restructuring: all phases from awareness to final restructuring results are reviewed. Omar lectures on bankruptcy law, directors' duties and liabilities.

Winter Storm Uri Two Years Later: A Look Back at the Brazos Bankruptcy Case and Other Uri-Related Bankruptcy Filings

April 12, 2023
Two years following the historic weather event that caused **widespread power outages across the State of Texas and would become** known as "Winter Storm Uri", the Turnaround Management Association (Houston Chapter) will host a breakfast meeting featuring **Jason Boland,** along with Kevin Lippman of Munsch Hardt & Harr and Jason Binford of Ross, Smith & Binford, who will revisit the weeks leading up to the storm, the legislative efforts surrounding the same, and will offer differing perspectives of various bankruptcy cases that followed.

Australian Restructuring Insolvency & turnaround Association (ARITA) – Vic/Tas Division Conference

May 9, 2023
Lee Pascoe will speak at the annual ARITA Vic/Tas Division Conference, with one of the representatives of the administrators of FTX in Australia, about the practical and legal issues facing insolvency practitioners when appointed to a business dealing in digital assets.

Australian Banking Association Conference

June 7–8, 2023
The annual Australian Banking Association conference in June will focus on the technological advancements and changing consumer trends that are impacting the future of banking. **Lee Pascoe** will speak at the conference on the impact of digital assets in the context of secured lending and enforcement. **Claudine Salameh** will moderate a panel focused on women's financial safety and, in particular, how the banking industry can continue to support customers who are victims of domestic financial abuse.

American Bar Association – Attorney-Client Privilege in Civil Litigation

Toby Gerber co-authored the bankruptcy chapter in the American Bar Association's *The Attorney-Client Privilege in Civil Litigation: Protecting and Defending Confidentiality* (7th Ed.). The chapter is titled "Litigating Attorney-Client Privileges Under the United States Bankruptcy Code and the Federal Rules of Bankruptcy Procedure." Toby co-authored the article with Jane A. Gerber of McDermott Will & Emery.

Global Restructuring Review

Francisco Vazquez and **Michael Berthiaume** co-authored an article – "When is a Cayman Islands liquidation not a foreign proceeding?" published in the February 14, 2023 edition of *Global Restructuring Review*.

M&A Community

Prof. Omar Salah was featured in an article by *M&A Community*, the leading Dutch platform for M&A professionals. In the interview, he discusses cryptocurrency insolvency together with James Sprayregen, Timothy Graulich and Jose Carlos. Omar focuses on the use of the Dutch WHOA – while comparing it to the US Chapter 11 – for cryptocurrency insolvency.

International Corporate Rescue

Francisco Vazquez's article "Lack of Sufficient Evidence Resulted in Denial of Recognition to Isle of Man Liquidation," was published in *International Corporate Rescue*, Volume 20, Issue 2.

ABI Journal

Bob Bruner and **Maria Mokrzycka** co-authored an article published in the *American Bankruptcy Institute Journal*, April 2023, entitled "The Business Judgement Rule Plus: Recent Applications of Heightened Scrutiny to Contract Rejections and Asset Sales Affecting the Public Interest." The article addresses developing standards and novel applications of the traditional business judgment rule to contract rejections and asset sales that implicate a public interest.

American College of Bankruptcy

Jason Boland was inducted as a Fellow in the American College of Bankruptcy's 34th class of inductees on March 24, 2023 in Washington, DC. The College consists of over 950 Fellows, each recognized for their professional excellence and exceptional contributions to the bankruptcy and insolvency practice.

Caution – Be mindful of Hong Kong's focus on COMI in recognising and assisting foreign liquidators

Camille Jojo, Daniel Ng, Alex Leung

Introduction

The COVID-19 pandemic is undoubtedly one of the biggest crises in recent times and has resulted in devastating impacts on every aspect of life across the globe. The situation has caused many businesses to become distressed, insolvent and ultimately either restructured, wound up or liquidated. Against this background, in October 2021, the Cayman Islands introduced a bill to amend its Companies Act so that a company can, by way of filing a petition for the appointment of a restructuring officer as opposed to a winding-up order, be entitled to an automatic global stay on claims against it. The bill came into force on 31 August 2022.

Prior to the reform in the Cayman Islands, as in some other offshore jurisdictions, companies had to first file a winding-up petition followed by seeking the appointment of "light-touch" provisional liquidators[1] in their place of incorporation in order to implement a restructuring that may be taking place in another jurisdiction. Whilst the reform symbolises an alternative route, for companies with assets outside their place of incorporation, it would be essential to consider whether, and to what extent those jurisdictions would offer recognition and assistance.

Recently, the Hong Kong Court has pushed back on rubber stamping recognition and assistance where the primary insolvency proceeding has been filed in the jurisdiction where the company is incorporated but in which the company has little to no business activity – the proverbial mail drop or letter box in some cases. Whilst the Hong Kong Court has caused angst in certain jurisdictions, a close look at the decisions show that the Court's reasoning and holdings are nuanced, provide some pathways to recognition and assistance and do not shut the door completely. Moreover, in some ways, it mirrors how the US courts have addressed recognition of offshore proceedings under Chapter 15 of the US Bankruptcy Code, which incorporates the Model Law on Cross-Border Insolvency. In the US, there are a series of decisions denying recognition to foreign proceedings pending in an offshore jurisdiction where the debtor is incorporated but did not historically conduct significant business. Other decisions, however, have clarified that the door to recognition remains open in the US provided there is a level of liquidation or reorganization activity in the foreign jurisdiction at the time the recognition request is made in the US.

Rationale for seeking a recognition and assistance order in Hong Kong

Before we delve into the details of Hong Kong's latest position on recognising and assistance to foreign insolvency processes, it may be helpful to understand why foreign insolvency practitioners have to make such application in Hong Kong in the first place.

In *Re Legend International Resorts Ltd* [2006] 2 HKLRD 192, the Hong Kong Court held that there is no power to appoint a provisional liquidator solely for the purposes of effecting a corporate rescue. Further, in *Re China Solar Energy Holdings Ltd (No 2)* [2018] 2 HKLRD 338,held that it is not permissible to appoint provisional liquidators in Hong Kong in order to restructure the debt of the company in the absence of any matter associated with a winding-up. That said, in *Re Joint Provisional Liquidators of Hsin Chong Group Holdings Ltd* [2019] HKCFI 805, the Hong Kong Court clarified it is permissible to appoint provisional liquidators for orthodox reasons and, after the provisional liquidators have familiarised themselves with the affairs of the company, for an interested party (commonly the provisional liquidators) to apply to court if it is thought desirable for restructuring powers to be granted to the provisional liquidators. The Hong Kong Court also noted in *Re CW Advanced Technologies* [2018] HKCFI 1705 that where the circumstances warrant the appointment of provisional liquidators, the provisional liquidators may be granted powers to explore and facilitate a debt restructuring.

1 A "light-touch" provisional liquidation enables the company to remain under the day-to-day control of its directors, but is protected against actions by individual creditors. This serves as an opportunity for the company to restructure its debts or otherwise achieve a better outcome for creditors than what would be achieved by liquidation.

Under section 186 of the Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the Laws of Hong Kong), no action or proceeding can be proceeded with or commenced against the company when a provisional liquidator has been appointed except with leave of the court. Therefore, whilst the appointment of a provisional liquidator would provide benefits to parties trying to restructure a distressed company during the stay, this only provides limited breathing space between the presentation of a petition and the eventual winding-up hearing. Further the presentation of a winding-up petition is deemed to be the commencement of liquidation and has significant adverse consequences for the distressed company as a going concern.

Given the limitation of the provisional liquidation regime in Hong Kong as noted above, it has been considered preferable for distressed foreign companies with assets in Hong Kong to be placed into provisional liquidation in a foreign jurisdiction in order to obtain an immediate moratorium, followed by the application by the provisional liquidators for a recognition and assistance order in Hong Kong.

Conventional practice in Hong Kong

As noted in *Joint Official Liquidators of A Co v B* [2014] 4 HKLRD 374, Hong Kong is not a party to the UNCITRAL Model Law on Cross-Border Insolvency, and Hong Kong's insolvency legislation contains no provisions dealing with cross-border insolvency. However, at common law the court has power to recognise and grant assistance to foreign insolvency proceedings. The Hong Kong Court may, pursuant to a letter of request from a common law jurisdiction with a similar substantive insolvency law, make an order of a type that is available to a provisional liquidator or liquidator under Hong Kong's insolvency regime.

While systems with similar common law insolvency regimes are the source of most applications for recognition and assistance in Hong Kong, this is not a prerequisite. The law is well-settled that the Hong Kong court will recognise foreign insolvency proceedings that comply with the following criteria:

1. the foreign insolvency proceedings are collective insolvency proceedings;
2. the foreign insolvency proceedings are opened in the company's country of incorporation.

So for example, in *Re Mr Kaoru Takamatsu* [2019] HKCFI 802, the court has recognised and provided assistance to a trustee in bankruptcy appointed in Japan. With an increasing number of applications for recognition and assistance, the Hong Kong Court has developed a standard practice on applications for recognition orders.

Relevant Hong Kong cases – Focus on COMI

Despite the standard practice, a number of recent Hong Kong decisions involving offshore-incorporated companies listed on the Hong Kong Stock Exchange appear to suggest that in considering whether or not to recognise and assist a foreign

liquidator under common law, the Hong Kong Court is more hesitant in recognising and/or assisting foreign liquidation, especially when it is commenced in the distressed company's place of incorporation (as opposed to where its centre of main interest (**COMI**) lies).

In *Re FDG Electric Vehicles Ltd* [2020] HKCFI 2931, whilst the Hong Kong Court acknowledged that it has a common law power to assist a foreign liquidation (in this case in Bermuda) by ordering a stay of proceedings within its jurisdiction so as to assist collective insolvency processes in view of the principle of universalism[2], it emphasised that this does not mean a foreign light-touch provisional liquidation is for all purposes to be treated as a collective insolvency process. Besides, under the *Gibbs* rule[3], a foreign incorporated company that is subject to a foreign collective insolvency process should not prevent a Hong Kong creditor from attempting to establish a right to payment under a Hong Kong-law governed contract in Hong Kong. For these reasons, the Hong Kong Court granted an order of recognition and assistance to the provisional liquidators to permit them to take control of FDG's assets in Hong Kong, but directed them to separately apply for stay of proceedings in Hong Kong should they wish to.

In *Re Lamtex Holdings Ltd* [2021] HKCFI 622, against the backdrop of an increasing number of companies having no connection with their places of incorporation (typically offshore jurisdictions) other than registration seeking recognition and assistance, the Hong Kong Court considered that the approach ought to be revised to give weight to the COMI of the company as follows:

1. Generally, the place of incorporation should be the jurisdiction in which a company should be liquidated; in practice this means it will be the system for distributions to creditors.
2. However, if the COMI is elsewhere, regard is to be had to other factors:
   a. Is the company a holding company, and, if so, does the group structure require the place of incorporation to be the primary jurisdiction in order to effectively liquidate or restructure the group.
   b. The extent to which giving primacy to the place of incorporation is artificial having regard to the strength of the COMI's connection with its location.
   c. The views of creditors.

On the facts, it was undisputed that the COMI of Lamtex was in Hong Kong and not in Bermuda where Lamtex was incorporated. However, there was scant information about the proposed restructuring. The Hong Kong Court was of the view that Lamtex had no credible plan to restructure its debt whether at the time of the appointment of the light-touch provisional liquidators in Bermuda or at the hearing before the Hong Kong Court. Instead, the Bermuda light-touch provisional liquidation appeared to be an attempt to engineer a *de facto* moratorium in Hong Kong with a view to searching for a solution to Lamtex's financial problems, which would not be permissible under Hong Kong law. As such, the Hong Kong Court granted a winding-up order against Lamtex.

In contrast, in *Re Ping An Securities Group (Holdings) Ltd* [2021] HKCFI 651, the Hong Kong Court applied the principles set out in *Re Lamtex* but adjourned the Hong Kong winding-up petition for two months and granted an order of recognition and assistance to the Bermuda provisional liquidators, as the Hong Kong Court was satisfied that the restructuring proposal of Ping An was feasible.

In *Re China Bozza Development Holdings Ltd* [2021] HKCFI 1235, the Hong Kong Court drew a distinction between recognising and assisting foreign liquidators. Whilst a foreign liquidator appointed in the place of incorporation of the company ought to be recognised as having the powers to act on behalf of the company bestowed on them, this does not mean that the Hong Kong Court would give active assistance to such foreign liquidator, and the liquidator should be prepared to provide details on the following issues in order to obtain an order of assistance:

1. the restructuring plan;
2. any creditor's input in formulating the restructuring plan;
3. the business of the company;
4. the reasons for the board of directors to consider that the business of the company might be rehabilitated through the restructuring plan; and
5. legal or other professional advice on the company's financial position and restructuring plan.

As this information was largely unavailable, owing to concerns over an abusive use of light-touch provisional liquidation in the Cayman Islands, and with a view to protecting creditors from exploitation, the Hong Kong Court granted a recognition, but not an assistance order to China Bozza's provisional liquidators at that stage.

2 That is, all of the company's assets are distributed to its creditors under a single system of distribution.

3 The rule provides that the discharge or compromise of liabilities under a contract shall be governed by the law of the contract.

Finally, in *Provisional Liquidator of Global Brands Group Holding Limited (in liquidation) v Computershare Hong Kong Trustees Limited* [2022] 3 HKLRD 316, the Hong Kong Court once again noted that the orthodox common law position in recognising foreign insolvency proceedings has led to issues in transnational restructuring and insolvency (which are commonplace due to the extensive use of holding companies incorporated in offshore jurisdictions but consisting of operating and asset owning subsidiaries in Hong Kong and mainland China), one of which is whether a jurisdiction in which the distressed company's business is conducted should recognise an insolvency process conducted in a place with which the company has no material economic connection. As such, the Hong Kong Court considered that it should move towards a COMI approach in assessing whether or not a foreign liquidation should be recognised. If, at the time the application for recognition and assistance is made, the foreign liquidation is not taking place in the jurisdiction of the company's COMI, recognition and assistance should be declined, unless the application falls within one of the following two categories:

1. Managerial assistance: recognition limited to the authority of the liquidator (if appointed in the place of incorporation) to represent the company and orders that are an incident of that authority; or
2. Assistance on practical grounds: recognition and limited, carefully prescribed assistance (which does not fall within the first category above) required by a liquidator appointed in the place of incorporation as a matter of practicality.

For the purpose of determining a company's COMI, factors to be looked at include where the company (i) conducts its management and operations, (ii) has its office, (iii) holds its board meetings, (iv) has its officers residing, (v) has its bank accounts, (vi) maintains its books and records, (vii) conducts restructuring activities, and (viii) files statutory records etc.

Applying the COMI approach, the Hong Kong Court granted an order for recognition and limited assistance to the provisional liquidator that was appointed in Global Brands' Bermuda liquidation so that he could demonstrate himself as the lawful agent of Global Brands to direct transfer of certain assets of Global Brands in Hong Kong.

Impact and practical realities

The signaling of a move towards the COMI approach in the recognition of, and assistance to, foreign liquidators under common law in Hong Kong has led to controversies. In particular, some foreign liquidators perceive the recent cases to be a departure from previous decisions, that such shift is overly protective, overlooks the commercial reality that the prospect of restructuring may gradually improve after restructuring is commenced, and that a restructuring does not necessarily benefit the shareholders at the expense of the company's creditors.

Nevertheless, having considered the overall scheme of things, we take the view that the recent line of cases remains consistent with the past cases. In the absence of corporate rescue legislation in Hong Kong, the Hong Kong Court has indeed been making great efforts in developing the common law mechanism of recognition and assistance to best assist distressed companies so as to fill the lacuna. Whilst such goal is of paramount importance, one must not lose sight of the Hong Kong Court's responsibility to safeguard against any abusive use of foreign light-touch provisional liquidation (typically commenced in the company's place of incorporation where the company only has a letter-box presence) when there is no credible restructuring plan and the only purpose would be to stifle any Hong Kong winding up petition against the distressed company. What can be gleaned from the recent cases is a positive development that the Hong Kong Court is now taking further steps to ensure that the grant of recognition and assistance is carefully scrutinised rather than a rubber-stamp exercise. Such spirit of rescuing companies (where there is a genuine proposal to such effect) is also evident from the Hong Kong Court's approach in cases involving schemes of arrangements. For instance, in respect of the winding-up petition against Hong Kong Airlines Limited (in which we represented one of the dissenting creditors), the Hong Kong Court allowed the petition to be adjourned on several occasions so that the proposed scheme of arrangement could be considered first before resorting to a winding-up order. No doubt the position in Hong Kong remains evolving, but we are confident that the Hong Kong Court will remain active in granting recognition and assistance to foreign liquidators under the modern approach.

Camille Jojo and Daniel Ng are partners in our Hong Kong office in the firm's global restructuring group. Alex Leung is an associate in our Hong Kong office in the firm's energy & construction disputes resolution group.

Year in review: Significant US Chapter 15 decisions in 2022

Francisco Vazquez

Introduction

Chapter 15 of the United States Bankruptcy Code incorporates the Model Law on Cross-Border Insolvency. As of the date of this article, 56 jurisdictions, including the US, Australia, Brazil, Canada, Japan, Mexico, Singapore, South Africa, and the United Kingdom, have adopted a version of the Model Law, which generally provides a procedure for a country to recognize a foreign insolvency, liquidation, bankruptcy, or debt-restructuring elsewhere.

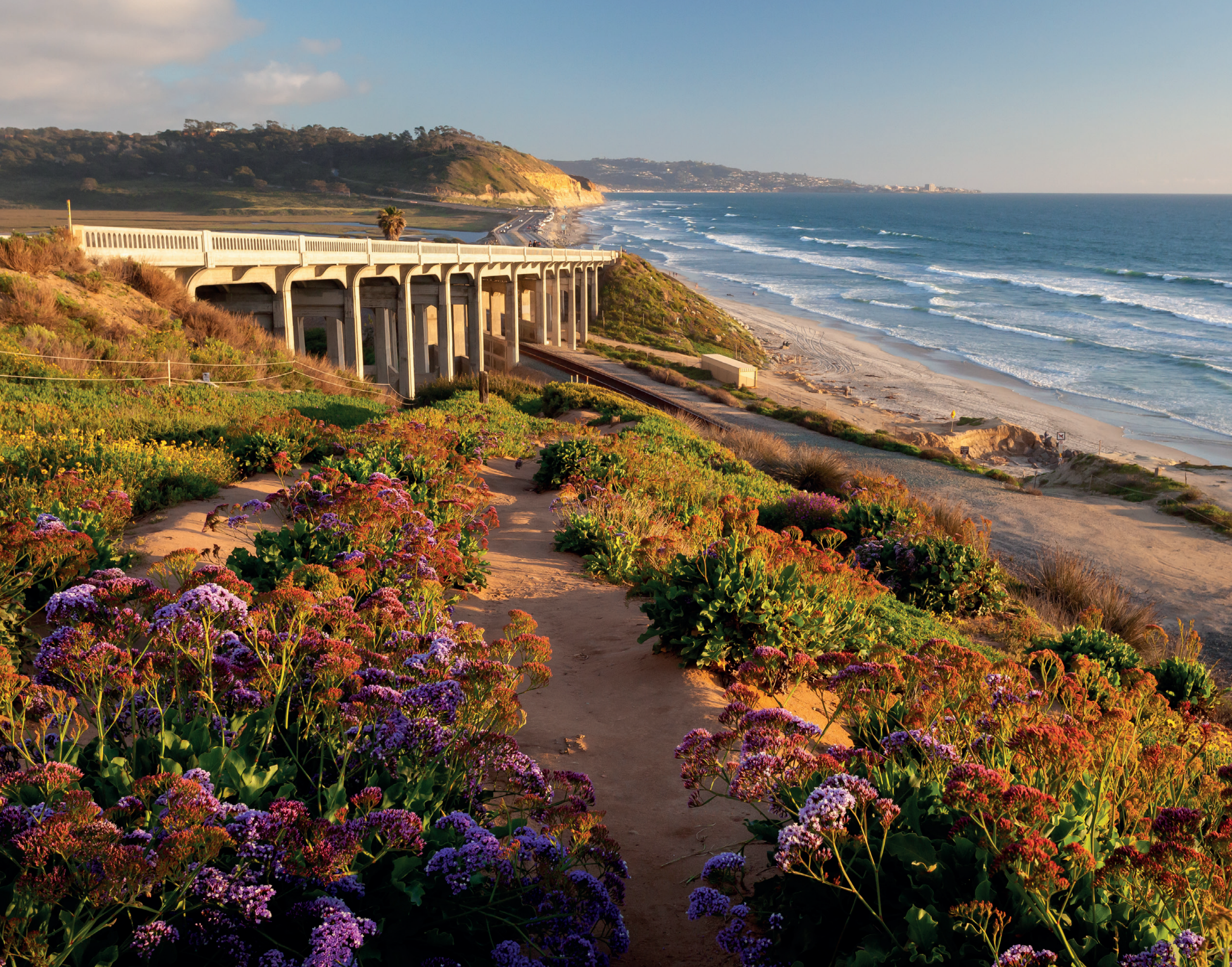
In 2022, US courts were presented with Chapter 15 petitions to recognize foreign proceedings pending in the Bahamas, Bermuda, Brazil, the British Virgin Islands, Bulgaria, Canada, Cayman Islands, Estonia, Hong Kong, Jersey, Indonesia, Isle of Man, Italy, Luxembourg, Mexico, the People's Republic of China, and the UK. Moreover, there were several written decisions issued in Chapter 15 cases last year. This article describes a handful of those decisions. Part I discusses an appellate court decision emphasizing the objective nature of recognition. Part II highlights a possible upcoming appellate court level split as to the imposition of the traditional US debtor-eligibility requirements to Chapter 15 cases. Part III describes two decisions that serve as reminders that a proceeding pending elsewhere must be a foreign proceeding and a foreign main or a foreign nonmain proceeding as defined in the Bankruptcy Code for it to be recognized in the US under Chapter 15. Part IV examines a decision in which a court reinforced a debtor's ability to restructure US governed debt outside the US. Finally, Part V summarizes a decision in which a court authorized service of a subpoena by email and social media.

I. Recognition is subject to an objective test

Section 1517 of the Bankruptcy Code generally provides that a foreign proceeding shall be recognized if three conditions are met. First, the foreign proceeding must be a "foreign main proceeding" or "foreign nonmain proceeding" as defined by the Bankruptcy Code. Second, the foreign representative must be a person or body. Finally, certain procedural requirements must be satisfied. In addition, some US courts have concluded that a foreign debtor must also satisfy the debtor-eligibility requirement applicable to a plenary proceeding under the Bankruptcy Code for a foreign proceeding to be recognized. However, as long as those objective requirements are met, a foreign proceeding must be recognized under Chapter 15 unless to do so would be manifestly contrary to US public policy.

In *In re Black Gold S.A.R.L.*, 635 B.R. 517 (9th Cir. B.A.P. 2022), a US appellate panel reversed a US bankruptcy court's decision denying recognition to a foreign proceeding on the basis that it was purportedly filed in bad faith. Black Gold S.A.R.L. was a Monaco company that distributed oil and related products manufactured and sold by, among others, International Petroleum Products and Additives Company ("IPAC"). According to IPAC, Black Gold and its insiders improperly used sensitive and confidential information to establish a competitor to IPAC. An arbitrator agreed and issued an award in favor of IPAC. Following IPAC's efforts to collect a judgment confirming the arbitration award, Black Gold filed an insolvency proceeding in Monaco ("Monegasque Proceeding"). Thereafter, Black Gold's foreign representative filed a petition for recognition of the Monegasque Proceeding with the US Bankruptcy Court for the Northern District of California.

IPAC opposed recognition of the Monegasque Proceeding under Chapter 15, arguing that recognition would be manifestly contrary to US public policy for two reasons. First, IPAC contended that Black Gold's insiders filed the insolvency proceeding and the Chapter 15 case in bad faith to evade liability for stealing intellectual property. Second, IPAC asserted that Monegasque law "dramatically restricted the rights and remedies a creditor enjoys under U.S. law." The bankruptcy court concluded that the Chapter 15 case



"was not a legitimate use of chapter 15 for the purposes and objectives as intended under § 1501." Thus, the bankruptcy court denied the Chapter 15 petition without even addressing the recognition requirements under section 1517.

On appeal, the appellate court acknowledged that section 1501 of the Bankruptcy Code identifies the broad scope and purpose of Chapter 15, but does not create substantive rights or govern recognition of a foreign proceeding. As the court noted, a foreign proceeding must be recognized as long as the section 1517 requirements are met.

With respect to section 1517, the court first concluded that the Monegasque Proceeding was a foreign proceeding as defined in the Bankruptcy Code. "The evidence established that the Monegasque proceeding is a collective judicial proceeding in Monaco, conducted pursuant to Monegasque insolvency law, in which the [debtor's assets] are subject to the foreign representative's control under the supervision of the Monegasque court for the purpose of reorganization or liquidation." Next, the appellate court found that all of the requirements of 1517 were satisfied. First, it was undisputed that the Monegasque Proceeding was a foreign main proceeding. Second, the foreign representative was a person appointed as a trustee and authorized to administer the reorganization or liquidation of the debtor's assets or affairs. Finally, there was no dispute that the procedural requirements were satisfied. Thus, the court concluded that the Monegasque Proceeding must be recognized under Chapter 15 unless recognition would be manifestly contrary to US public policy.

Section 1506 of the Bankruptcy Code allows a court to refuse to grant relief under Chapter 15 if it "would be manifestly contrary to the public policy of the United States." US courts have rarely invoked this public policy exception, finding that

it "should be invoked only under exceptional circumstances concerning matters of fundamental importance." According to the court, the differences between Monegasque and US procedural and substantive law were "tolerable," and as such did not implicate the public policy exception.

Citing to several decisions in support, the appellate court further held that misconduct or bad faith by the debtor or an insider was not a basis to deny relief under Chapter 15. Moreover, in this instance, the alleged improper conduct did not violate US public policy. As the court noted, the Chapter 15 case and the Monegasque Proceeding, like many other bankruptcy cases, was filed to "thwart collection efforts." That was not unique. Indeed, US bankruptcy petitions are often filed for a similar reason.

Because the foreign representative had satisfied the section 1517 requirements, the appellate court concluded that the Monegasque Proceeding must be recognized. Misconduct and bad faith alone are not sufficient to deny recognition under the public policy exception. The appellate court, however, emphasized that the bankruptcy court could otherwise address the misconduct if necessary and appropriate. For example, the court could lift the stay resulting from recognition of the Monegasque Proceeding as a foreign main proceeding and allow litigation to proceed against the debtor in the US.

II. Foreign debtor does not need to be eligible to be a debtor in the US for its foreign proceeding to be recognized

According to the US Court of Appeals for the Second Circuit (which includes New York), a foreign debtor must satisfy the general debtor-eligibility requirements set forth in the Bankruptcy Code for its foreign proceeding to be recognized. *See Drawbridge Special Opportunities Fund LP v. Barnet (In re Barnet)*, 737 F.3d 238, 247 (2d Cir. 2013). Under section 109(a) of the Bankruptcy Code, "only a person that resides or has a domicile, a place of business, or property in the United States…may be a debtor." 11 U.S.C. § 109(a). Therefore, New York bankruptcy courts will recognize a foreign proceeding only if the debtor has a residence, domicile, place of business, or an asset in the US.

As noted in last year's "Year in Review," a district court in Florida, which is a common forum for Chapter 15 cases, disagreed with the Second Circuit and concluded that section 109(a) does not apply in Chapter 15 cases. *See In re Al Zawawi*, 637 B.R. 663 (M.D. Fla. 2022). That decision was appealed to the US Court of Appeals for the Eleventh Circuit. As of the date of this publication, the Eleventh Circuit has not issued its ruling. However, if the Eleventh Circuit affirms, there would be a split as to the applicability of section 109(a) to Chapter 15 cases that may need to be resolved by the US Supreme Court or further legislation.

III. A US court may only recognize a "foreign proceeding" that is pending in the debtor's center of main interests or where it has an establishment

Chapter 15 applies where "assistance is sought in the United States by a foreign court or a foreign representative in connection with a foreign proceeding." 11 U.S.C. § 1501(b). The Bankruptcy Code defines a foreign proceeding as "a collective judicial or administrative proceeding in a foreign country . . . under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation."

In *In re Global Cord Blood Corp.*, No. 22-11347, 2022 WL 17478530 (Bankr. S.D.N.Y. Dec. 5, 2022), the bankruptcy court for the Southern District of New York denied a petition to recognize a Cayman Islands proceeding brought under section 92(e) of the Cayman Islands Companies Act (the "Section 92(e) Proceeding"), finding that the proceeding was not a "collective proceeding brought for the purpose of reorganization or liquidation."

Section 92(e) of the Companies Act permits a court to order the winding up of a company when it would be "just and equitable" regardless of the financial condition of the debtor. Here, the Grand Court of the Cayman Islands issued an order under section 92(e) directing the appointment of Joint Provisional Liquidators ("JPLs") to preserve the value of Global Cord's assets and to investigate and report on Global Cord's corporate affairs. The Grand Court's order further authorized the JPLs to commence winding-up or insolvency proceedings. The JPLs, however, concluded that Global Cord was solvent and, therefore, did not commence such a proceeding. Instead, the JPLs filed a Chapter 15 petition for recognition of the Section 92(e) Proceeding.

An interested party objected to recognition, arguing that the Section 92(e) Proceeding was not a foreign proceeding because it was not (1) under a law relating to insolvency or

adjustment of debt, (2) a "collective" proceeding, and (3) for the purpose of reorganization or liquidation. The US court found that section 92(e) was contained in the Companies Act, which like other offshore companies acts, is a comprehensive statute that also addresses, among other things, a company's insolvency and winding-up. Thus, according to the court, the proceeding was generally under a law relating to insolvency of adjustment of debt. However, the liquidator failed to satisfy two other elements of a foreign proceeding.

First, the Bankruptcy Court found that the Section 92(e) Proceeding was not a collective proceeding. In general, a proceeding is collective if it inures to the benefit of all creditors and concerns all interests of the creditor body as a whole. In this instance, creditors were not given notice of the proceeding. Moreover, the particular proceeding was not a forum for the JPLs to identify creditors, to quantify and classify Global Cord's debts, or to make distributions to creditors. Given the limited creditor participation and the lack of notice to creditors, the Bankruptcy Court found that the Section 92(e) Proceeding was not a collective proceeding.

Second, the Section 92(e) Proceeding was not for the purpose of reorganization or liquidation. Instead, the proceeding was brought to investigate alleged misconduct by the debtor and its insiders. It bore little, if any, connection to Global Cord's financial condition and was not intended to address the debtor's assets or liabilities. Thus, the Bankruptcy Court concluded that the proceeding could not be recognized under Chapter 15. The court, however, noted that it may grant recognition to the Section 92(e) Proceeding at a later date should the JPLs engage a process to liquidate or restructure Global Cord.

A foreign proceeding may be recognized if it is a foreign main proceeding or a foreign nonmain proceeding. If the foreign proceeding is neither, it cannot be recognized. A foreign main proceeding is a proceeding pending in the debtor's center of main interest or "COMI" which is not defined in the Bankruptcy Code. However, a debtor's COMI is presumed to be the location of its registered office absent evidence to the contrary. A foreign nonmain proceeding is a proceeding pending where a debtor has an "establishment," which means "any place of operations where the debtor carries out nontransitory economic activity." In 2022, the US Bankruptcy Court for the Western District of Oklahoma denied a Chapter 15 petition for recognition of an Isle of Man liquidation, finding that the proceeding was not a foreign main proceeding or a foreign nonmain proceeding. *In re Paul Shimmin, as Liquidator of Comfort Jet Aviation, Ltd.*, Case No. 22-10039 (Bankr. W.D. Okla. Oct. 14, 2022).

In this instance, the Isle of Man was presumed to be Comfort Jet's COMI. However, the evidence demonstrated that Comfort Jet's COMI was elsewhere. In particular, Comfort Jet's registered address on the Isle of Man was merely a "letter box." Moreover, the liquidator failed to produce any evidence regarding Comfort Jet's operations there. Instead, the evidence produced—including the location of the debtor's assets, creditors, and managers—reflected that the debtor's COMI was somewhere other than the Isle of Man. Finding that this evidence was insufficient to conclude that Comfort Jet's COMI was the Isle of Man, the court denied recognition of the liquidation as a foreign main proceeding.

The court further found that the liquidation could not be recognized as a foreign nonmain proceeding because Comfort Jet did not have an establishment in the Isle of Man. According to the court, the foreign representative must demonstrate "a local effect on the marketplace, more than mere incorporation and record-keeping and more than just the maintenance of property" to satisfy the establishment requirement. Comfort Jet's liquidator, however, failed to satisfy that burden.

IV. US courts do not apply the Gibbs Rule and may enforce a foreign restructuring of debt governed by US law

The UK and certain other jurisdictions have adopted the "Rule in Gibbs," which traces its origin to a decision by the English Court of Appeal in *Anthony Gibbs & Sons v. LaSociete Industrielle et Commeciale de Mataux,* (1890) 25 QBD 399, where the court refused to recognize a French discharge of debt governed by English law. Under the Rule in Gibbs, debt generally can only be discharged or modified under the applicable governing law. Thus, for example, English law governed debt can generally only be discharged under English law. However, there is an exception. Under the Rule in Gibbs, debt can be discharged or modified under the law of a jurisdiction other than the situs of the governing law if the creditor owed the debt submits to the jurisdiction of that foreign court.

In 2022, a court in Hong Kong, which applies the Rule in Gibbs, concluded that US law-governed debt may only be discharged or restructured under US law. *Re Rare Earth Magnesium Technology Group Holdings Ltd* [2022] HKCFI 1686. Thus, according to the Hong Kong court, an offshore proceeding, even if recognized by a US court under Chapter 15, would not necessarily be effective to discharge or

restructure US law governed debt. Subsequently, the US Bankruptcy Court for the Southern District of New York clarified the possibility of discharging or restructuring US law governed debt under foreign law. *In re Modern Land (China) Co. Ltd*, 641 B.R. 768 (Bankr. S.D.N.Y. 2022).

Modern Land (China) Co. Ltd. is a Cayman Islands company with NY law governed bond debt. It is a holding company with subsidiaries incorporated in the Cayman Islands and the British Virgin Islands. Most of the group's business is conducted in the People's Republic of China. Facing liquidity pressures, Modern Land proposed a scheme of arrangement in the Cayman Islands to restructure the NY law governed bonds. In addition, Modern Land filed a petition for recognition of the Cayman Islands proceeding and an order enforcing the scheme in the US under Chapter 15.

In its opinion, the bankruptcy court squarely addressed the Hong Kong court's comments regarding US law, noting the importance of the ability to modify or discharge NY law governed debt in a foreign proceeding. The bankruptcy court noted, with great respect to the Hong Kong court, that it had misinterpreted US law. According to the US bankruptcy court, Chapter 15 may limit a US court's authority to enjoin actions against a debtor and its assets to the territorial jurisdiction of the US, but it does not limit a foreign court's ability to discharge US law governed debt. "Provided that the foreign court properly exercises jurisdiction over the foreign debtor in an insolvency proceeding, and the foreign court's procedures comport with broadly accepted due process principles, a decision of the foreign court approving a scheme or plan that modifies or discharges New York law governed debt is enforceable." Thus, the *Modern Land* decision reinforced the longstanding and "unremarkable proposition" that a US court can recognize and enforce a foreign restructuring of US law governed debt.

Ultimately, the bankruptcy court granted recognition to the Cayman Islands proceeding as a foreign main proceeding. According to the court, the evidence, including the creditors' expectations and the judicial role and the insolvency activities in the Cayman Islands, supported a finding that the debtor's COMI was the Cayman Islands. Further, the court recognized and enforced the scheme that restructured the NY law governed bonds, in the US.

V. A US court may authorize service of a subpoena on a US national located outside the US by email and social media

A foreign representative often needs information to identify, locate, and recover a debtor's assets for the benefit of the debtor's creditors and other stakeholders. Under Chapter 15, a court may authorize a foreign representative to seek discovery from any person "concerning the debtor's assets, affairs, right, obligations or liabilities." *See* 11 U.S.C. §1512(a)(4). However, a foreign representative must nevertheless comply with certain procedural requirements. In particular, rule 45 of the Federal Rules of Civil Procedure, made applicable in bankruptcy cases (including Chapter 15) by Federal Rule of Bankruptcy Procedure 9017, generally requires personal service of a discovery subpoena. In 2022, the US Bankruptcy Court for the Southern District of New York authorized service of a subpoena on a US citizen by email and social media. *See In re Three Arrows Cap., Ltd.*, 647 B.R. 440 (Bankr. S.D.N.Y. 2022).

Three Arrows is a BVI investment firm that was engaged in trading cryptocurrency and other digital assets. In June 2022, Three Arrows went into liquidation in the BVI. Thereafter, the official liquidators obtained recognition of the BVI liquidation in the US under Chapter 15. In addition, the liquidators obtained authority from the bankruptcy court to seek discovery and to issue subpoenas in the US.

Despite their efforts, the liquidators were purportedly unable to obtain information from the debtor's founders, who had key information regarding the debtor's affairs and assets. Moreover, the liquidators did not know where the founders were actually located. Accordingly, the liquidators asked the court to authorize service of subpoenas outside the US by email and social media.

The bankruptcy court divided its analysis between service on US nationals or residents and non-US nationals or residents. The bankruptcy court noted that Rule 45 authorizes service of a subpoena on a US national or resident in a foreign country. The bankruptcy court, however, found that Rule 45 does not authorize service of a subpoena outside the US on a non-US national or resident. Thus, the bankruptcy court did not allow the liquidators to serve a subpoena outside the US on the founder that was not a US national or resident.

The foreign representative demonstrated that one of the debtor's founders was a US national. Under Rule 45, a US national or resident may be served with a subpoena in a foreign country in accordance with 28 U.S.C. § 1783, which generally authorizes the issuance of a discovery subpoena if discovery (1) is necessary in the interest of justice, and (2) not possible to be obtained in any other manner. Here, the bankruptcy court found that both elements were satisfied. First, the discovery was necessary. In particular, the bankruptcy court concluded that the founders, who were "paramount" to the debtor's organization, "might arguably be the only parties with knowledge regarding the nature, extent, and access to the Debtor's assets, particularly as they are connected to the United States in this Chapter 15 case." Second, there were no other practical methods to obtain the discovery. Indeed, the founders were likely the only persons with the information requested and they had not cooperated with the liquidators' discovery requests. Hence, the court authorized the liquidators to serve a subpoena outside the US on the US national founder.

The court noted that Rule 45 typically requires personal service of a subpoena. However, citing to existing precedent, the bankruptcy court concluded that it could authorize alternative service of the subpoena that was "reasonably calculated" to provide actual notice to a discovery target.

In this instance, the court was "convinced that alternative service via email and Twitter would be warranted and reasonably calculated to provide notice." According to the court, the founder had provided the email address to the liquidators. Moreover, the liquidator had demonstrated that the founder had used the email and Twitter accounts. Thus, the court allowed the liquidators to serve a subpoena on the US national by email and social media. It remains to be seen whether the founder will comply with the subpoena and what relief the liquidators may obtain should the founder ignore the subpoena.

Conclusion

Congress enacted Chapter 15, in part, to foster cooperation between US courts and foreign courts. However, a court will typically not grant relief under Chapter 15 solely because it would be consistent with Chapter 15's goals. Instead, a court must be satisfied that a foreign representative has satisfied its statutory requirements before granting relief. A US court will typically not grant relief solely because it would be equitable or consistent with Chapter 15's objectives.

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English High Court awards £90million to liquidator in landmark preference claim

Radford Goodman, Helen Coverdale

In November 2022 the High Court in London awarded the liquidators of British electronics retailer, Comet Group Ltd ("Comet"), approximately £90 million following a successful preference claim.[1] This is understood to be the largest preference award in English legal history. The claim was vigorously contested, and the judgment contains a detailed analysis of the law relating to preferences in the context of a complex distressed M&A transaction.

Background

Comet was founded in 1993 and by 2011 it operated 249 stores and was one of the UK's largest electrical retailers. Comet was owned by the Kesa group (**Kesa**) and the members of Comet's board were senior Kesa executives, including Kesa's CEO, CFO and Group General Counsel.

Comet began experiencing financial difficulties in 2010, when it reported a loss of £3.8 million. The following year, the loss had increased to £31.8 million. Kesa sought to exit its investment in Comet and invited interested parties to submit bids. OpCapita, a private equity fund specialising in distressed retailers, agreed to buy Comet as a going concern through a share sale. Kesa was keen to sell Comet as a going concern for wider, reputational reasons and wanted a deal that involved a "clean break" to cap its downside risk. One of the pre-requisites for the deal was that Kesa required repayment by Comet of a £115 million intercompany unsecured revolving credit facility granted by Kesa International Limited (Kesa's group treasury company) (**KIL**) (the **KIL RCF**). The funds to repay KIL were to come from a new loan made by Hailey Acquisitions Limited (**HAL**) (the **HAL RCF**), which was to be the buyer of the Comet shares. The HAL RCF was to be fully secured against Comet's assets. These terms were documented in a SPA (to which Comet was not a party), which was entered into in November 2011.

The SPA provided that Comet was to enter into a completion agreement, prior to which all but one of Comet's directors would resign and be replaced by new board members made up of the purchaser's nominees (the **New Board**).

In February 2012, following a review of Comet's financial position, the New Board approved entry into the Completion Agreement and the HAL RCF and repayment of the KIL RCF.

Following the transfer, Comet continued to trade until November 2012, at which point it went into administration.

The elements of a preference claim under English law

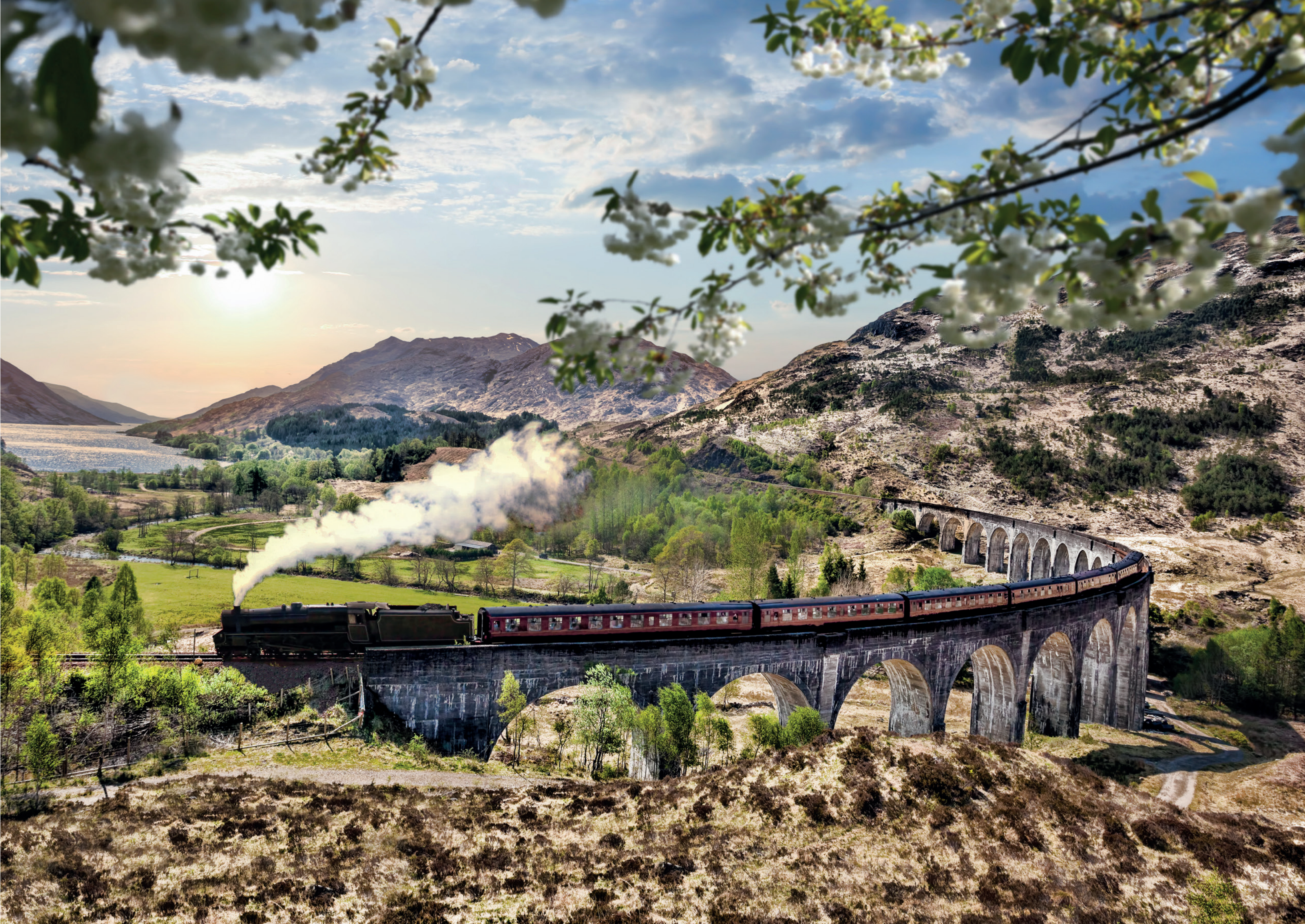
Under English law, a company gives an unlawful preference where it does something (or suffers something to be done) which has the effect of putting a creditor in a position which, in the event of the company's subsequent insolvency, will be better than the position it would have been in had the thing not been done. Typically, a preference involves paying a particular creditor whilst others are left unpaid.

Once the basic premise of a preference has been established, further criteria must be satisfied.

First, the preference must have been given within six months of the commencement of administration or liquidation. However, this is extended to two years if the parties are connected (as was found to be the case with KIL and Comet in a preliminary hearing).

Secondly, at the time of the alleged preference, the company must have been insolvent or it must have become insolvent as a result of the preference.

1 The claim was brought under section 239 of the Insolvency Act 1986 and is reported at *Re CGL Realisations Limited* [2022] EWHC 2873 (Ch). We understand that this judgment is subject to a pending appeal to the Court of Appeal.



Thirdly, and crucially, the company must have been *influenced by a desire* to put the recipient of the preference in a better position than would otherwise have been the case in the company's liquidation. Where the parties are connected (as was the case with Kesa and Comet), the desire to prefer is presumed, but this presumption may be rebutted by evidence to the contrary. Existing case law has clarified that a *desire to prefer* is subjective and need not be the dominant purpose of the transaction.

Timing is also important: the presence or otherwise of a desire to prefer must be assessed at the time of the decision to enter into the relevant transaction. This will not be necessarily when the transaction actually occurred.

The claim and Darty's defences

The repayment of the RCF was not initially challenged by Comet's administrators but in 2018 (by which time the administration had been converted into a liquidation) an independent conflict liquidator was appointed to investigate the transaction.

Proceedings were commenced in October 2018 against the French electricals company, Darty Holdings (Kesa's successor) (**Darty**). Darty submitted (amongst other things) that:

1. there was no desire to prefer KIL on the part of Comet. In particular, Darty argued that the directing mind of Comet was the New Board and the New Board, made up principally of the purchaser's nominees, had no desire to prefer KIL;
2. Comet was not insolvent at the relevant time; and
3. even if there was a preference, the court should exercise its discretion against making an order because there were 'exceptional circumstances,' including the fact that the preference had been part of a larger transaction and there was now no simple way to restore the position to what it would have been if the preference had never been given.

The decision of the High Court

Addressing each of these arguments in turn, the High Court (Mrs. Justice Falk) held that:-

1. The disposal of Comet was deliberately structured to have the effect that the RCF was repaid, and Kesa "*positively desired to achieve that result*". One member of the core deal team for Kesa was a director of Kesa at group level and also a director of Comet: he acted on behalf of the Kesa Group as a whole, including Comet. The Judge found that "*Kesa was driven entirely by the desire for a clean break, whilst meeting its objective of leaving Comet with a capital structure that could allow it to continue as a going concern. No separate interest of Comet was perceived to exist*." In the circumstances, even though Comet had not been a party to the SPA, the Judge held that this did not prevent the key decision to repay the KIL RCF having effectively been made *on behalf of Comet* at the time of the SPA. Thus, by the time the New Board was put in place to approve completion, the decision to enter into the transaction (including the repayment of the KIL RCF) had already been made and what occurred at completion in February 2012 was "*a formal, albeit necessary, step to allow that decision to be implemented*." The Judge found that whilst, in theory, the New Board could have refused to approve the deal, "*in substance the decision had already been taken*": if the New Board had refused to implement that decision they "*would have been sacked and replaced*". In such circumstances, their role was merely "*careful choreography*", and the *desire to prefer* was to be assessed by reference to Comet's board at the time of the SPA.
2. Comet was insolvent on a balance sheet basis at the time of the repayment of the RCF. In particular, having heard expert witnesses for both parties, the Judge concluded that it was not appropriate in the circumstances to include a deferred tax asset of £44 million on the balance sheet, as Comet had done in statutory and management accounts. Without this "asset", Comet's balance sheet showed substantial negative net assets.
3. Just because the preference may have been part of a larger, complex transaction does not mean that the court should decline to make an order. The court must "do the best it can" and the appropriate award "*is one that restores the position to what it would have been if a preference had not been given*." In this case, this was the difference between the £115.4m repaid to Kesa and the dividend that Kesa would have received as an unsecured creditor in a hypothetical liquidation of Comet if the sale of Comet had never occurred.

Take Aways

Although concerned specifically with English law on unlawful preferences, this case is of broader import insofar as it provides a reminder that the interests of an insolvent company (and by extension its creditors) must be considered separately and independently from its wider group or the larger transaction when structuring any distressed M&A transaction or debt restructuring. Failure to do so will heighten the risk of challenge if the company were subsequently to fail. The High Court's focus on the underlying substance to determine when, and by whom, relevant decisions were made further illustrates that courts will be prepared to look through the form and any perceived corporate "choreography" when considering claw back claims.

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Australia's unfair preference laws – what lies ahead for liquidators in a period of legislative reform and dynamic change in the courts?

Scott Atkins, Alex Mufford, Laura Johns, Natasha Toholka, Steven Palmer, Jeffrey Black, Jenna Scott

Introduction

There are provisions in Australia's corporate insolvency laws which enable a company's liquidator to recover a payment, that is made to a creditor within a prescribed period of time before the commencement of the company's insolvency case, if the payment amounts to an "unfair preference."

As Priestley LJ noted in his judgment in *Harkness v Partnership Pacific Ltd* (1997) 23 ACSR 1, the unfair preference provisions derive from 18th century English legislation, and further the bankruptcy principle that a single creditor cannot be preferred over the general body of unsecured creditors by way of the disposition of an insolvent company's assets outside the collective process provided for by the insolvency system. The unfair preference rules reflect and preserve the *pari passu* principle – that all unsecured creditors, subject to express statutory exceptions, are to rank equally in the distribution of the insolvent estate.

Unfair preference recoveries by a company's liquidator were previously based on provisions in the *Bankruptcy Act 1996* (Cth) (**Bankruptcy Act**), which were incorporated by reference into the companies legislation. However, with effect from 23 June 1993, standalone provisions were included in the former Corporations Law, which are now reflected in sections 588FA to 588FI of the *Corporations Act 2001* (Cth) (**Corporations Act**).

Those provisions are structured so that if a company enters into a transaction with a creditor, which:

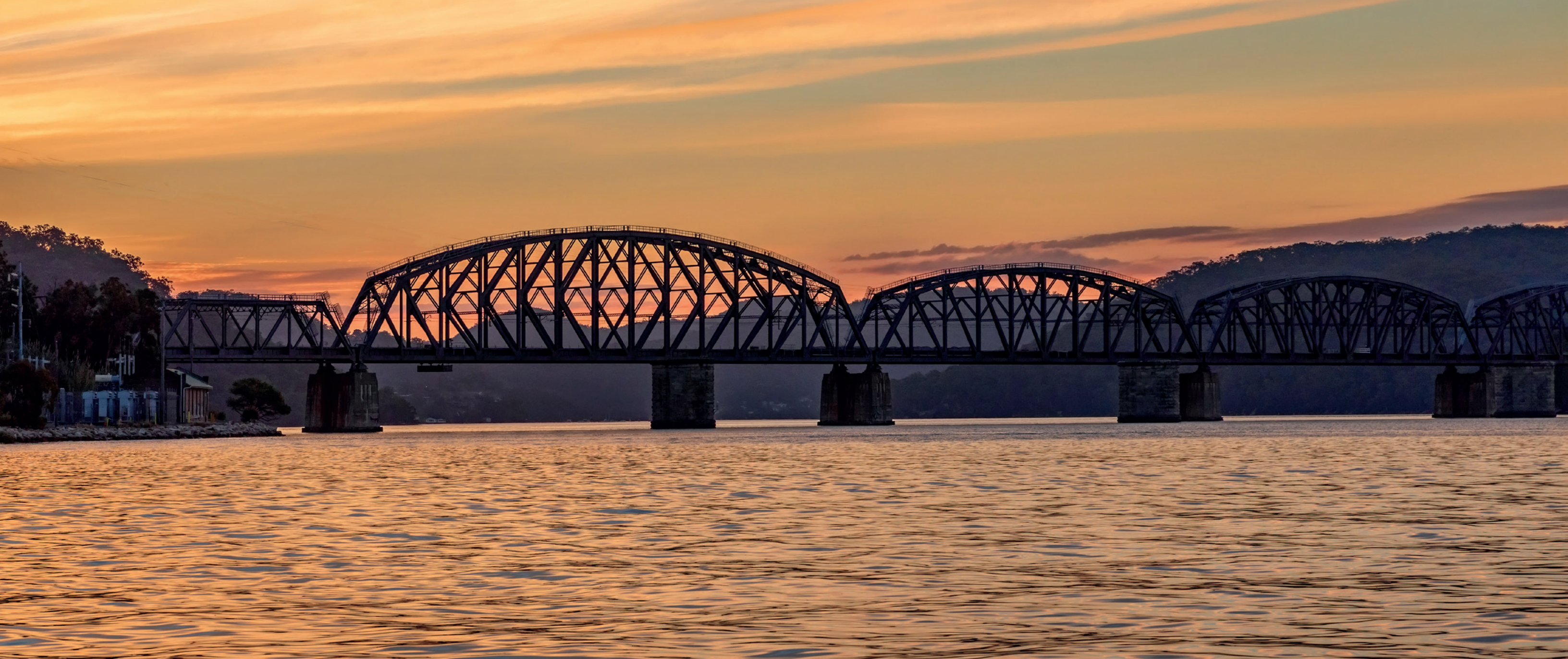
- occurred during a prescribed period of time or claw back period – ranging from six months, to four years where a creditor is a related entity of the company, and to 10 years where there is an intention to defeat the rights of other creditors – before the "relation back day" (generally the time the winding up application was filed or a voluntary administrator appointed);
- occurred when the company was insolvent or caused the company to become insolvent; and
- enabled the creditor to recover more than it would if it had received a proportionate share of the company's assets, along with all other unsecured creditors, in the company's liquidation.

the transaction can be set aside upon the application of the company's liquidator (see sections 588FA, 588FC and 588FE of the Corporations Act).

This article seeks to explore some of the key issues canvassed by Australian courts in defining the purpose, scope and practical implications of unfair preference provisions as a feature of corporate insolvency law over the last 30 years, and looks ahead to the impact of two recent High Court of Australia decisions and impending legislative reform on liquidator recoveries.

The common law doctrine of ultimate effect

According to the express words in section 588FA(1)(b) of the Corporations Act, a payment to a creditor will amount to an unfair preference whenever the creditor receives more than it would by proving its debt in the company's winding up – even if the company receives equal or greater value in return. This is in contrast to the corresponding provision in section 122(1) of the Bankruptcy Act, according to which a payment must have the effect of "giving the creditor a preference, priority or advantage over other creditors" before it can be recovered by a liquidator.



Nevertheless, Australian courts have taken the approach that it is necessary to look at the *ultimate effect* of a transaction in assessing whether there is an unfair preference – in essence, imposing a requirement for a transaction to *in fact* be preferential and to give a creditor an unfair advantage before it can be recovered under section 588FA of the Corporations Act (see, for example, *VR Dye & Co Peninsula Hotels Pty Ltd (in liq)* (1999) 32 ACSR 27). This means that if, at around the same time when a creditor is repaid the outstanding debt owed to it by the company, the creditor provides identifiable new goods or services to a company, the payment is unlikely to be considered an unfair preference. That is because, rather than simply discharging pre-existing indebtedness, the company's payment can be considered to have been made to induce the supply of those new goods or services to the company. The company receives a tangible benefit linked to the payment, so that creditors have not suffered any element of disadvantage.

Running accounts

There is now a specific statutory codification of the doctrine of ultimate effect where there is a "running account" between a company and a creditor engaged in a "continuing business relationship", under which there are regular debits and credits arising from a company's payments to the creditor, and the creditor's ongoing supply of goods or services to a company over time.

The statutory provision was recommended in the Harmer Report, the first major inquiry into Australia's insolvency laws held in 1988.

Despite the difficulty of directly linking any individual payment to an identifiable "new" supply of goods or services in a running account scenario, section 588FA(3) of the Corporations Act expressly permits the court to examine all of the dealings as part of a *single* transaction in assessing whether a creditor has, on the whole, received an unfair preference across the running account period.

The running account principle reflects the idea that an insolvent company's general body of unsecured creditors are not disadvantaged by payments made to trade creditors that cause further goods or services to be supplied to the company that are of an equal or greater value.

Even where the parties do not have a running account in place as part of a continuing business relationship, the courts will resort to the broader doctrine of ultimate effect as a general law defence to an unfair preference claim (see *VR Dye & Co*).

The *Badenoch* case – rejection of "peak indebtedness"

In assessing the preferential effect of payments to a creditor under the statutory running account exception, a liquidator was previously entitled to compare the *peak indebtedness* of the company to the creditor during the relation back period to the lowest point of indebtedness during that time, and to claim the difference as the value of the unfair preference (see *Rees v Bank of New South Wales* (1964) 111 CLR 210). This maximised both the likelihood of ascertaining an unfair preference and the amount of any unfair preference.

The peak indebtedness rule was not without controversy – and has often been criticised on the basis that it cuts across the policy rationale to encourage trade creditors to continue to provide value to companies in financial distress, thereby enhancing the prospect of a distressed but viable business being able to trade while it negotiates with creditors and works to implement a restructuring plan (whether informally or as part of a formal insolvency process).

The controversy has now been settled by the High Court of Australia in a recent landmark decision. In *Bryant v Badenoch Integrated Logging Pty Ltd* [2023] HCA 2 (***Badenoch***), the High Court unanimously rejected the application of the peak indebtedness rule in assessing the preferential effect of transactions arising as part of a continuing business relationship.

The High Court held that the peak indebtedness rule is "unexplained in the decisions which embody it" (at para 58). According to Jagot J, the natural and ordinary meaning of section 588FA(3) of the Corporations Act is that *all* transactions forming part of a continuing business relationship under the running account principle must be taken into account in assessing if there has been a net unfair preference. Allowing the liquidator to select the peak indebtedness of a company to a creditor as the starting time to assess the net preferential effect is "arbitrary" and does not "serve the purpose of the running account principle". Indeed:

> The purpose of the running account principle is not to maximise the potential for the claw-back of money and assets from a creditor, but that is the effect of the peak indebtedness rule. The running account principle recognises that a creditor who continues to supply a company on a running account in circumstances of suspected or potential insolvency enables the company to continue to trade to the likely benefit of all creditors (at para 70).

The High Court resolved the uncertainty that remained from the decision of the Full Federal Court – which had suggested that, if the peak indebtedness rule did not apply, the "single transaction" arising from a running account could begin prior to the statutory claw back period – potentially requiring a liquidator to investigate years of trading history between the company and a creditor to assess, over the entire business relationship, if there was a net preference.

The High Court determined that, where the continuing business relationship started before the prescribed claw back period, the relevant transactions forming part of the relationship – in the context of an unfair preference claim – must be transactions *within* the claw back period and those which were entered into when a company was insolvent or had the effect of causing the company to become insolvent.

The High Court also clarified that, in determining whether a transaction forms part of a continuing business relationship, it is necessary to look to the objective character of the payment and the actual business relationship between the parties (at para 81). The subjective intention of the creditor is not conclusive – so even if a creditor receives a payment with the intention of continuing to supply services to the company, the payment could still be an unfair preference if, on an objective assessment, the payment is primarily explained as a reduction of past indebtedness (at para 85).

The decision in *Badenoch* makes it considerably more difficult for a liquidator to recover unfair preference claims from creditors. Liquidators no longer have the benefit of being able to select the most optimal time period from which to calculate the net preferential effect of payments made while a running account was in place between a company and a creditor during the statutory claw back period. Instead, liquidators will have to assess the net effect of all transactions over the period, and this will likely mean that preference claims will be less frequent and, when made, will be of a lesser amount particularly where the continuing business relationship is established. This, however, is faithful to the policy principle underlying the common law and now statutory ultimate effect defence.

The *Morton* case – a creditor cannot set-off against an unfair preference claim

The question of whether a creditor may rely on statutory set-off in section 553C of the Corporations Act as a defence to an unfair preference claim had remained unresolved for two decades. However, in a long-awaited decision handed down on the same day as the decision in *Badenoch*, the High Court determined this issue in *Metal Manufactures Pty Ltd v Morton* [2023] HCA 1 (***Morton***).

The High Court unanimously held that statutory set-off is not available in this circumstance. The result is that a creditor is not entitled to deduct any outstanding claim that it might have against a company from its liability to repay the company's liquidator any unfair preference.

The High Court held that a debt owed to a creditor, and a creditor's liability to repay an amount as an unfair preference, lack the requirement of there being mutual credits, mutual debts or other mutual dealings between a creditor and the insolvent company (as prescribed by section 553C of the Corporations Act). Specifically, an outstanding debt is owed by the company to a creditor, while an unfair preference liability is owed by the creditor to the company's *liquidator*. Additionally, the interest of the parties in these amounts differs – the payment of the debt is for the benefit of the creditor, while the recovery of the unfair preference is for the benefit of the company's creditors (see at paras 52-53). Further, it was held that section 553C of the Corporations Act limits the pool of claims that are provable in a winding up

to those debts payable by and claims against the company, “the circumstances giving rise to which occurred *before* the [winding up].” Yet amounts owing as an unfair preference only arise upon the making of a court order *after* the commencement of the winding up – another basis for set-off being unavailable in a preference claim (at para 49).

This case is welcome news to liquidators – with a significant obstacle to the recovery of unfair preference claims being removed. This will result in enhanced returns for the general body of unsecured creditors – due to both the unavailability of the substantive set-off defence itself, as well as the time and cost savings from litigating the set-off issue in the absence of a final High Court position on its application in a preference matter.

Takeaways

Unfair preferences have traditionally formed an important component of a liquidator’s prospective recoveries when a company is wound up. The frequency of preference claims is reflected in the significant body of court decisions on important principles, such as the doctrine of ultimate effect, running accounts, the peak indebtedness rule, and statutory set-off.

Over the last three decades, preference recoveries have been especially aided by the ability of a liquidator to rely on the peak indebtedness rule in the context of a continuing business relationship between a company and a creditor.

The recent decisions of the High Court in *Badenoch* and *Morton* present a mixed bag for liquidators. On the one hand, the rejection of the peak indebtedness rule will inevitably reduce the value of preference recoveries, as liquidators are now required to examine *all* transactions made between the company and a creditor in a continuing business relationship (provided they occur during the statutory claw back period) in assessing whether there has been a net preference.

On the other hand, the inability of creditors to rely on set-off as a defence will remove a key obstacle that has previously hampered liquidator recoveries.

The net result is that liquidators will now need to recalibrate their strategy and resources in assessing preference claims – in many cases, the commencement of unfair preference proceedings will no longer be viable because establishing an advantage to a creditor will be difficult due to the decision in *Badenoch*.

That said, the battlefield may shift with liquidators’ focus likely turning to seeking to establish that a continuing business relationship ended due to circumstances perhaps indicating that payments to a creditor were motivated to secure the discharge of past indebtedness rather than induce ongoing supply

Outside of a continuing business relationship, creditors will no longer be able to rely on set-off as a defence to an unfair preference claim by a liquidator.

We can also expect future legislative change to unfair preferences. In May 2022, the former Coalition Government announced that transactions that either amounted to less than AUD $30,000, or that were made more than three months prior to the company entering external administration, will no longer be able to be clawed back, provided those transactions involve unrelated creditors and are within the ordinary course of business.

These amendments are yet to be enacted under the new Labor Government, although new reforms could be announced following the conclusion of the current broad-based inquiry into the effectiveness of Australia’s corporate insolvency laws being conducted by the Parliamentary Joint Committee on Corporations and Financial Services. The inquiry intends to report to the Parliament in May 2023

Unfair preferences will remain an area of dynamic change in Australia, and it will be important for all practitioners to keep a close eye on future developments.

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Insolvency law reform and capacity building in emerging markets: Bhutan, Armenia and Myanmar lead the way

Scott Atkins, John Martin

Law reform designed to strengthen local insolvency processes has become a key focus area as we continue to face challenging economic and financial circumstances across the world. As interim COVID-19 insolvency relief measures have come to an end, governments are now turning their attention to implementing permanent measures that enhance efficiency, flexibility and predictability in the insolvency process.

It is generally considered that a best-practice insolvency system should seek to achieve two key outcomes: the effective restructure of distressed but viable businesses, and the simple, efficient reallocation of the assets of unviable businesses towards more productive uses.

But predictable, well-designed insolvency laws are not just about what happens when a business *fails*. Rather, as the World Bank has noted, insolvency laws focused on the end of the business life cycle also have a profound impact on the beginning. Specifically, banks and investors are more willing to advance funds to businesses when they know there are clear and effective processes in place that will coordinate their claims and allow them to maximise their recoveries in the event of financial distress. Effective insolvency laws also encourage a greater entrepreneurial culture, without the stigma of business failure and the risk of losing everything if things do not work out as planned.

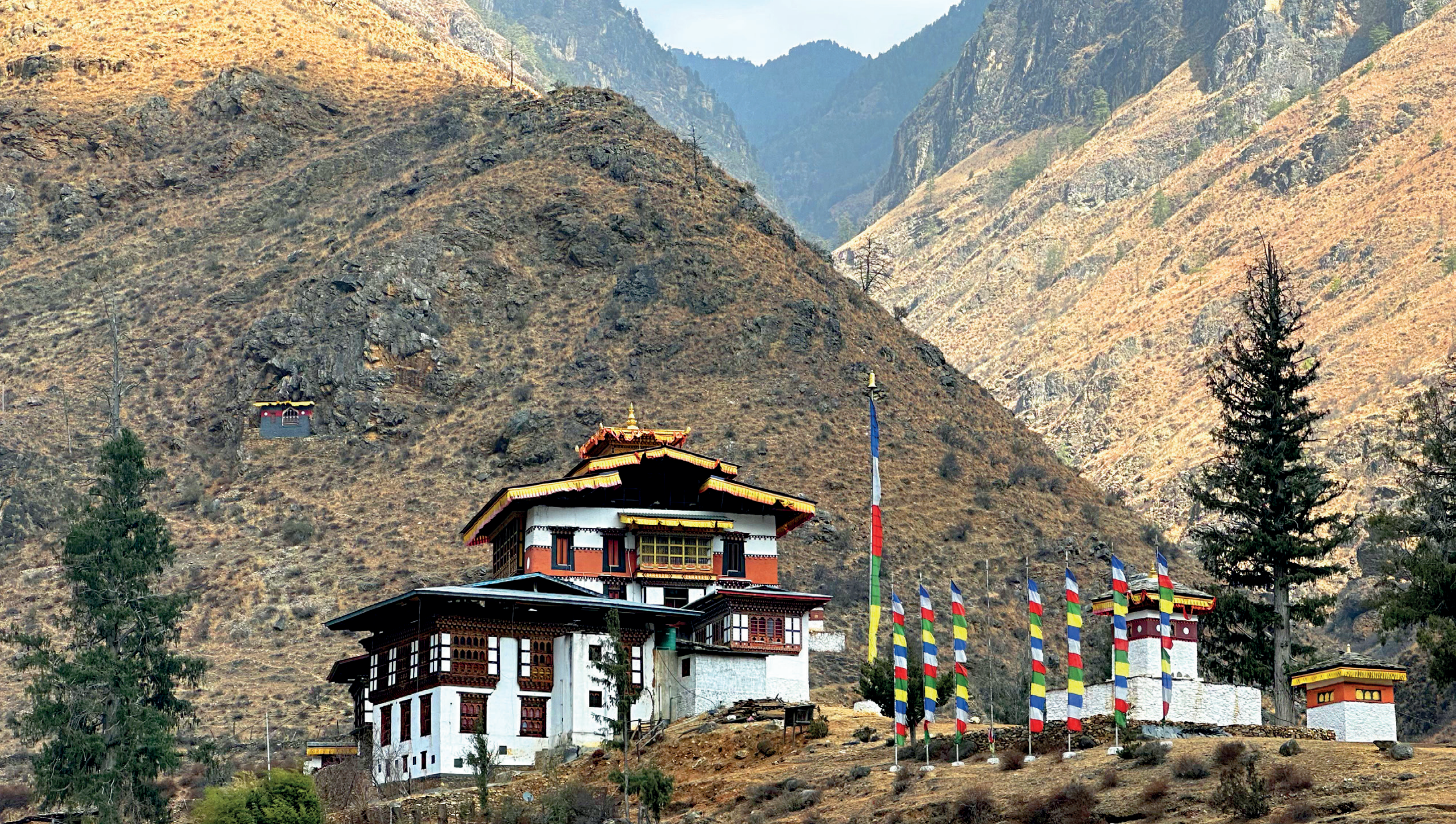
In that sense, insolvency law reform drives an active investment market, with greater access to credit for companies at lower cost – which in turn supports job creation, innovation, productivity and economic growth. In periods of economic downturn, insolvency laws help to ensure financial stability, the maintenance of jobs and the preservation of livelihoods and communities.

These outcomes are especially important now in emerging market and developing economies (**EMDEs**). In its latest Global Economic Prospects Report issued in January 2023, the International Monetary Fund (**IMF**) estimated that, by the end of 2024, GDP levels in EMDEs will be around 6% below the levels expected before the pandemic, with challenges for business and investor confidence and incentives to generate long-term growth.

In that context, Scott Atkins (Global Chair, Australia Chair, Global Co-Head of Restructuring, Head of Risk Advisory and President of INSOL International) and John Martin (Partner and President of the International Insolvency Institute) are currently leading a team from Norton Rose Fulbright (which also includes Rodney Bretag and Sophie Timms) for the Asian Development Bank (led by Nicholas Moller) that is helping in the design and implementation of new insolvency laws in the Kingdom of Bhutan.

Scott and John visited Bhutan from 6-11 February 2023 and met with a broad range of government, institutional and business stakeholders as part of the initial reform consultation process. At the same time as their work in Bhutan, Scott and John are also undertaking a similar insolvency law reform project in the Republic of Armenia for the Asian Development Bank. Since early 2022, Scott and John have been involved in extensive stakeholder consultation sessions, and a program for law reform is now being designed in collaboration with government, judicial, institutional and business officials.

These projects follow the five year insolvency law reform and capacity building project that Scott and John led for Norton Rose Fulbright in the Republic of the Union of Myanmar between 2016 and 2021 for the Asian Development Bank. Together with the Asian Development Bank and the Union Supreme Court of Myanmar, the team from Norton Rose Fulbright helped to draft and oversee the enactment of Myanmar's Insolvency Law 2020, which came into effect on 25 March 2020.



The challenge in Myanmar was to design a new insolvency law that was reflective of international best practice but which could also be integrated into the existing regulatory, economic and social framework, where the experience of financial distress was very limited and the economy itself was in a state of transition. This challenge is also shared in the current Bhutan project.

During the Myanmar engagement, after comprehensive project phases involving research and analysis of the most efficient and effective insolvency frameworks and policy development and consultation with public and private stakeholders, legislative drafting was undertaken, together with feedback from the World Bank and the IMF, before the Insolvency Law was passed by Myanmar's Parliament on 14 February 2020.

Myanmar's Insolvency Law has since become regarded as a leading example of best practice insolvency processes across the world. The end result – and the work that was undertaken to get there – will inform the current work Scott and John are leading in Bhutan and Armenia, subject, of course, to local social and cultural traditions, influences and practices.

In terms of the substantive design of best practice insolvency processes, of particular note is the inclusion of a dedicated rescue procedure, and a simplified liquidation procedure, for micro and small enterprises (**MSEs**) in Part VI of Myanmar's Insolvency Law. Tailored MSE processes are among the key recommendations in the design of modern insolvency regimes outlined in the World Bank's Principles for Effective Insolvency and Creditor/Debtor Regimes, UNCITRAL's Legislative Recommendations on the Insolvency of Micro and Small Enterprises and the Asian Principles of Business Restructuring. This is because MSEs account for the substantial majority of businesses worldwide (up to 95% on the World Bank's latest estimate), and play a key role in contributing to job creation and global economic development. In real terms, MSEs are the lifeblood of any economy.

Subsequent to the introduction of Myanmar's Insolvency Law, bespoke MSE insolvency processes have been introduced in other jurisdictions – including the United States, Singapore, Australia and Indonesia.

Also significant in Myanmar's Insolvency Law is the ability for a rehabilitation advisor acting during a MSE restructuring process to appoint a mediator to help in resolving creditor disputes and to guide creditors towards the adoption of a negotiated restructuring plan. Contained in section 118 of the Insolvency Law, this may be the only specific [statutory] power of its kind in the world, and it could serve as a useful model for other jurisdictions. Mediation is already a common and successful feature encouraged by many US Bankruptcy Judges and used in US chapter 11 cases to achieve negotiated restructurings. Indeed, the World Bank, UNCITRAL and INSOL International have all recognised mediation as having the potential to support more effective restructuring outcomes for distressed entities, whether informally or in tandem with hybrid and formal court-based restructuring processes.

The implementation of the UNCITRAL Model Law on Cross-Border Insolvency as part of Myanmar's Insolvency Law is also a key feature of a best practice insolvency process – having been shown to enhance foreign investment and business confidence due to the predictable, principled system for cross-border recognition and cooperation that promotes efficiency, minimises costs and increases the likelihood of successful restructuring outcomes. This is highly appealing for both creditors and debtors in determining where and how to invest funds and structure businesses in a globalised, interconnected world.

Prior to the military coup in Myanmar, Norton Rose Fulbright's engagement also involved capacity building – working with international commercial judges to help train the local judiciary in the administration of the new laws, and also engaging with government, business and NGO stakeholders to explain modern insolvency concepts and the processes required to support the new laws.

Similar institutional building efforts are also envisaged in the Bhutan and Armenia projects. After all, the effectiveness of an insolvency regime correlates directly with the strength of the institutions responsible for interpreting, regulating and administering the underlying laws and the skills and specialised knowledge of the practitioners at the coalface.

Further updates will be provided as the Bhutan and Armenia projects continue over the next few years. It is an exciting time for Norton Rose Fulbright to be helping to lead the design and implementation of new insolvency systems across the world, which will directly contribute to economic growth and community development in EMDEs in the future.

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Canadian legislation aimed at protecting pension plans may mean significant changes for lenders, borrowers and employees

Candace Formosa

It is common practice for a lender to require that a fixed or floating charge be held over assets of a borrower to secure a loan. Logically, the higher the likelihood of a lender being unable to recover the amount of the loan, the less likely a lender is willing to provide capital to the borrower at a low cost.

Canadian insolvency legislation sets out the scheme of distribution that dictates how the proceeds of an insolvent party's assets will be distributed. Generally, secured creditors have priority over the proceeds of their collateral. However, certain liabilities are afforded super priority within insolvency proceedings, putting them ahead of the interests of secured creditors. Currently, pension benefits and entitlements for solvency deficiencies in defined benefit pension plans are not captured by this super priority.

As the current Canadian insolvency statutes stand, super priority is only afforded to an employer's pension liabilities to the extent that these liabilities are:

- unpaid amounts that were deducted from employees' remuneration for payment to the pension fund; or
- unpaid "normal costs", defined contributions, and certain other ordinary course amounts.

On February 3, 2022, Bill C-228 was introduced as a private members bill and has now made its way to the third reading in Canada's Senate. The purpose of Bill C-228 is to greatly expand the pension liabilities that are afforded super priority status by amending bankruptcy and insolvency legislation. As currently drafted, the Bill will grant priority for a pension plan's unfunded liability or solvency deficiency claims over the claims of the majority of creditors -- including secured creditors -- unless specifically enumerated otherwise in the statutes.

The "unfunded liability" is the amount necessary to enable the fund to continuously pay member benefits as they come due, on the assumption that the fund will operate for an indefinite period of time. The "solvency deficiency" includes the amount necessary to ensure the fund meets its obligations if wound up. As these amounts are constantly fluctuating, a fixed value cannot be ascribed to either of these requirements other than through a single point in time calculation by an actuary.

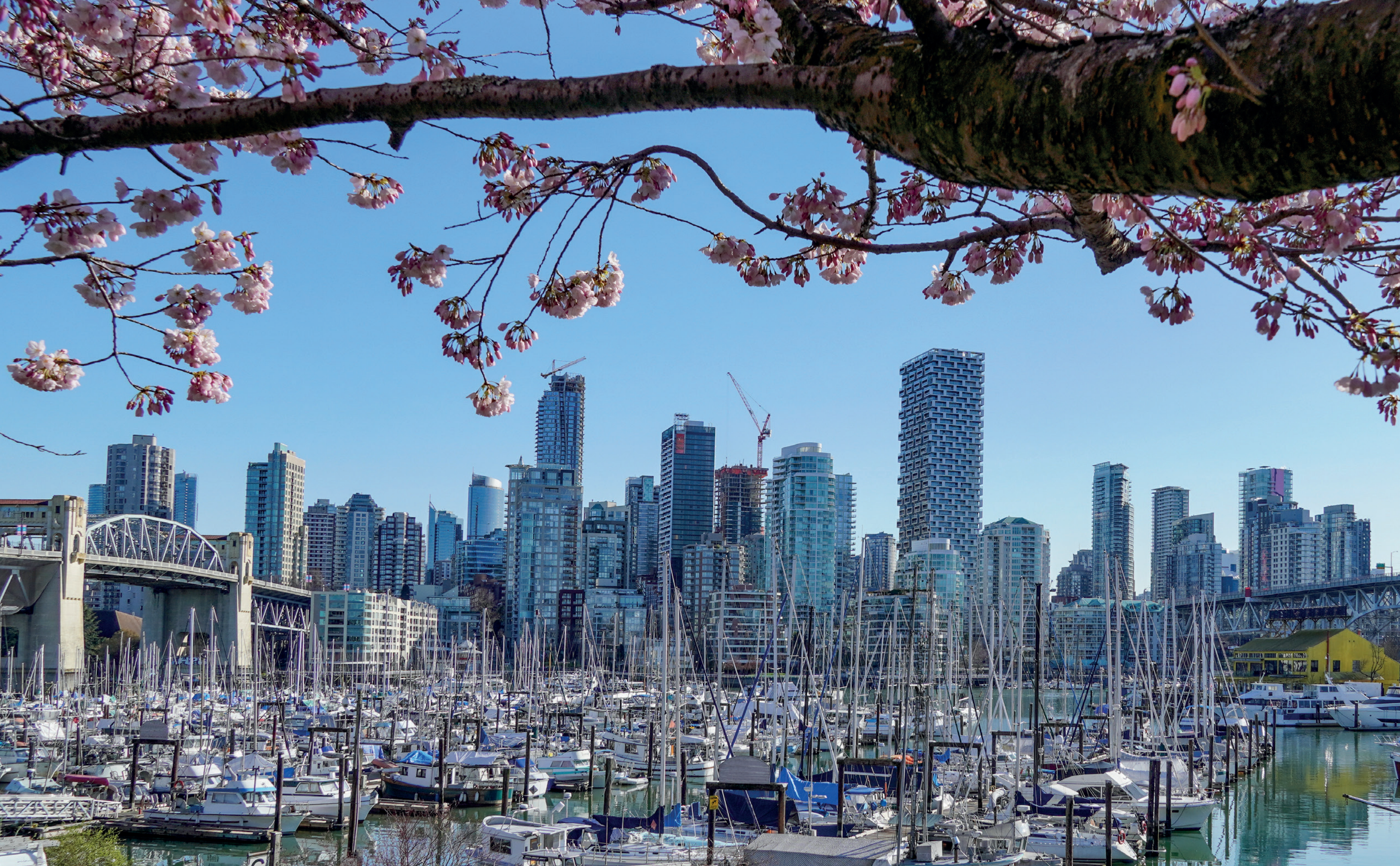
What does this mean for borrowers with pension plans?

Clearly, Bill C-228 would substantially increase the opportunity for recovery of pension entitlements within insolvency proceedings by way of super priority. The issue is whether it remains viable for lenders to provide capital to borrowers with defined benefit pension plans given the increased risk profile that may be created by Bill C-228 expanding the pension claims that take priority over a secured creditor in an insolvency case.

In all likelihood, Bill C-228 will minimally effect borrowers that have defined-contribution pension plans as the employer's liability is restricted to predefined contributions. As this type of plan is subject only to ordinary course known contribution requirements, and given that the employer does not guarantee a certain amount of income in retirement, the liability afforded super priority in insolvency proceedings should be predictable in most circumstances.

Conversely, Bill C-228 will significantly impact defined-benefit pension plans. These types of plans commit to providing a specified level of income in retirement based on a variety of factors. As such, an employer must diligently manage the pension fund to ensure it is in a position to pay the benefit to the employee for the remainder of their life, once retired. The inherent challenge with these plans is the uncertainty of the liability of the employer at any given time and the potentially large scope of that liability based in part on external factors such as interest rate fluctuations.

Bill C-228 has therefore created a conundrum. Although the intention of the Bill is to protect pension plans, it may potentially cause a shift that results in even more employers moving from a defined-benefit pension plan to a defined-contribution pension plan. Plainly, this shift may be caused



by lenders' concerns regarding the uncertainty surrounding the amount necessary to liquidate an unfunded liability or solvency deficiency at any given time. In other words, a lender will not be able to determine prior to the lending decision, with any great certainty, the amount of the unfunded liability or solvency deficiency in a future insolvency proceeding. At a minimum, a secured creditor wants to know the quantum of obligations that will take priority over their interests. This is essential information in deciding the quantum of a loan, the terms of such loan, any reserves and whether the creditor will agree to loan any money to the borrower.

Given this risk and uncertainty, lenders may limit the granting of credit and/or increase the cost to borrowers that maintain defined-benefit pension plans. As such, if Bill C-228 is passed, we may see employers shifting from defined-benefit pension plans to defined-contribution plans to secure more desirable financing options. If an employer fails to make this switch, we may see a heightened refinancing risk for these borrowers.

What lenders need to know

If Bill C-228 is passed, the transitional provisions provide that the amendments to the insolvency legislation will not come into force until four years following its enactment. During this time, it is prudent that financial lenders determine whether their borrowers have defined-benefit pension plans. If so, a lender may wish to evaluate the increased risk profile that may be caused by this enactment to assess whether new covenants, reserves or limits should be imposed. This may include covenants that require enhanced reporting mechanisms in respect of pension plans or increased interests rates to balance the additional uncertainty or additional default triggers related to pension plan deficits.

Alternatively, a lender may raise the issue with its borrowers to put them on notice that additional covenants and limits may be implemented for employers that have defined-benefit pension plans. This dialogue may encourage a discussion on whether the borrower will be taking steps to shift their pension plan to a defined-contribution plan, thereby eliminating the need for additional restrictions and covenants.

Progression of Bill C-228

Bill C-228 completed the second reading on December 14, 2022. The Standing Committee on Banking, Commerce and the Economy presented a report without any amendments on March 7, 2023. The final step is for the Senate to complete one more reading. If the Senate adopts the Bill without further amendments, royal assent will be granted shortly thereafter.

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The fate of Texas Two Step in the US dealt setback in appellate ruling

Michael Berthiaume

The "Texas Two Step" has become common (albeit controversial) parlance in US chapter 11 arenas as US courts grapple with the device made possible by Texas state law—specifically "divisive mergers" that offer a unique tool for Texas entities to manage exposure to potential mass tort claims. Under Texas law, a merger includes not only companies merging into one, but also includes the opposite-- when a company divides into two or more entities. These are known as "divisive mergers," and Texas is the only state aside from Delaware to allow a divisive merger (but Delaware only does so for limited liability companies).

The process known as a "Texas Two Step" involves (1) a company undergoing a Texas divisive merger and separating its assets and liabilities among two new entities, then (2) placing the liability burdened new entity into chapter 11, which halts litigation, and then seeking a channeling injunction and third party releases in favor of its related (and asset holding) entities under a chapter 11 plan.

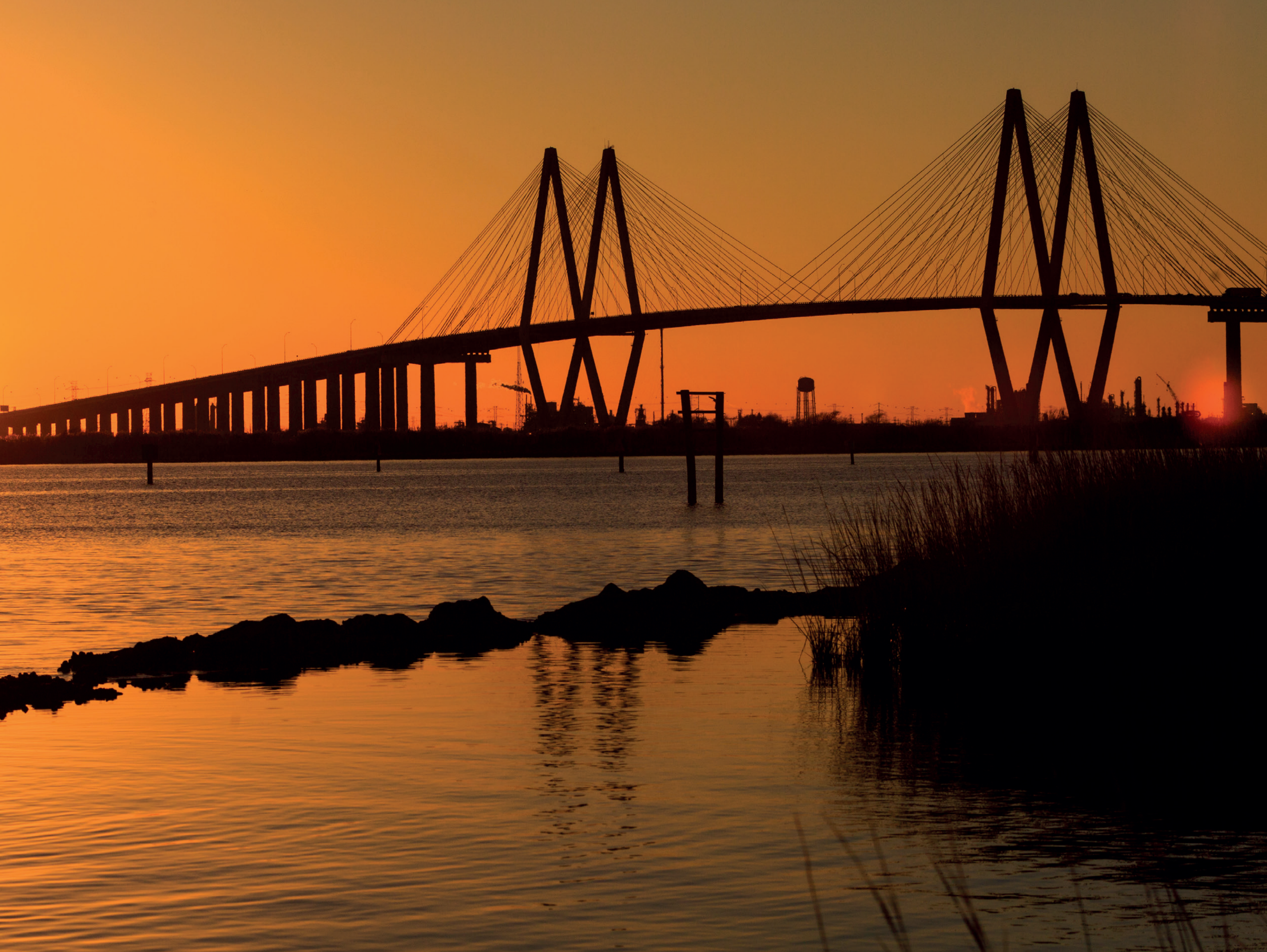
Critics of the scheme have alleged the Texas Two Step's re-allocation of assets and liabilities should not be condoned by the US Bankruptcy Code. Critics argue, *inter alia*, that such a chapter 11 petition is filed in bad faith, which constitutes cause for dismissal of the case. What constitutes good or bad faith, however, is not explicitly defined in the US Bankruptcy Code. Although US courts have attempted to define their contours by observing the equitable nature of bankruptcy law and the overall purpose of chapter 11, the courts have developed different standards in determining whether a chapter 11 petition is filed in good faith.

Specifically, the Third Circuit Court of Appeals recently held that a Texas Two Step case, *In re LTL Management*, was not filed in good faith, and, hence should be dismissed. This decision stands in opposition to a decision in another (albeit lower) court, which denied a previous attempt to strike down a Texas Two Step case in this manner. That case, *In re Bestwall*, applied a "much more stringent standard for dismissal" articulated by the Fourth Circuit Court of Appeals. Therefore, while the Third Circuit dismissed *In re LTL Management* as filed in bad faith, it remains to be seen whether other Texas Two Step cases will be successfully challenged in this manner.

A. The Third Circuit dismisses *In re LTL Management* for bad faith filing

On January 30, 2023, the Third Circuit ordered that the Texas Two Step chapter 11 case *In re LTL Management* be dismissed as a bad faith filing. Johnson & Johnson Consumer Inc. ("Old Consumer"), a wholly owned subsidiary of Johnson & Johnson ("J&J"), manufactured, among other things, Johnson's Baby Powder, which contained talc. Concerns that talc contained traces of asbestos—and therefore caused mesothelioma and ovarian cancer—spurred numerous lawsuits against Old Consumer and J&J. Old Consumer, therefore, undertook the "divisive merger" strategy afforded by Texas law, splitting into two new entities. One entity, Johnson & Johnson Consumer, Inc. ("New Consumer"), held all assets of Old Consumer. The other entity, LTL Management LLC ("LTL"), held all liabilities of Old Consumer. LTL's corporate parents entered into an agreement with LTL that provided LTL with funding from New Consumer and J&J ("LTL Funding Agreement") to cover LTL's liabilities, including costs associated with funding a trust to address talc liability.

After the divisive merger, LTL filed a petition for relief under chapter 11 of the Bankruptcy Code in the US Bankruptcy Court for the Western District of North Carolina, where other Texas Two Step cases had been commenced. That court, however, ultimately transferred the case to the US Bankruptcy Court for the District of New Jersey. Thereafter, the Talc Claimants Committee ("TCC") moved to dismiss LTL's bankruptcy case as a bad faith filing. The bankruptcy court denied the TCC's motion to dismiss. While the bankruptcy court appeared to doubt whether LTL would exhaust its right to payment under the LTL Funding Agreement, the bankruptcy court nonetheless held that LTL's filing served a valid bankruptcy



purpose, and that LTL was in "financial distress" by viewing the scope and costs of the talc litigation faced by Old Consumer and the effect of those costs on its business.

On appeal, the Third Circuit Court of Appeals observed that bankruptcy petitions are subject to dismissal under Section 1112(b) of the US Bankruptcy Code unless filed in good faith. The appellate court found that good faith requires a chapter 11 petition be filed (1) for a valid bankruptcy purpose, and (2) not to obtain a tactical litigation advantage. A valid bankruptcy purpose presumes a debtor is in "financial distress" and filed its petition to preserve a going concern or to maximize the value of its estate. The Third Circuit emphasized that, while financial distress does not necessarily require a debtor to be insolvent, a debtor who does not suffer from immediate financial distress cannot demonstrate that its petition serves a valid bankruptcy purpose supporting a good faith filing. A general desire to benefit from the provisions of the US Bankruptcy Code may not justify a presence in bankruptcy without financial distress.

The Third Circuit held that based on the facts LTL was not in financial distress. In reaching this conclusion, the Third Circuit first ruled that only LTL's financial condition is determinative, and that its financial state should be viewed independent of any other entity— namely, Old Consumer and New Consumer. The Third Circuit found the value of LTL's assets, including the LTL Funding Agreement (which was valued at US $61.5 million), meant that LTL was highly solvent with sufficient access to cash to meet its liabilities as they came due. Particularly, the LTL Funding Agreement gave LTL direct access to J&J's "exceptionally strong" balance sheet. This, coupled with the bankruptcy court's over-estimation of LTL's future talc liabilities, meant that LTL would not exhaust its rights under the LTL Funding Agreement and the bankruptcy filing was "at best premature." Perhaps, the Third Circuit surmised, with the progression of talc litigation outside of bankruptcy, LTL may one day demonstrate that cash available under the LTL Funding Agreement is insufficient to meet talc liabilities. LTL, however, had not made such a showing and its chapter 11 filing thus served no proper purpose.

In re LTL Management marks the first bad faith dismissal of a Texas Two Step case. While seemingly a win for critics of the Texas Two Step, the facts may limit any broad application in Texas Two Step cases. Specifically, the Third Circuit's finding of bad faith largely hinged on the LTL Funding Agreement, which allowed LTL to continue to fund its liabilities. Other Texas Two Step transactions, however, may not feature such agreements that afford means to fund all projected liabilities. In fact, the Third Circuit imagined such a scenario, acknowledging that its logic might "suggest LTL need only part with [the LTL Funding Agreement] to render itself fit for a renewed filing." It can be reasoned that an entity with no comparable funding agreement, for example, would face immediate financial distress in meeting its liabilities and would, therefore, enter chapter 11 with a valid purpose, even in the Third Circuit.

On March 22, 2023, the Third Circuit denied a request from LTL seeking a rehearing of its ruling en banc. LTL requested the Third Circuit stay the dismissal mandate pending LTL's expected petition for review by the United States Supreme Court. but that motion for a stay was denied by the Third Circuit on March 31, 2023. The next chess move involved LTL and J&J replacing the LTL Funding Agreement with a new arrangement that provides for New Consumer and/or J&J to backstop (if needed) funding for an $8.9 billion bankruptcy plan trust that resolves all talc claims in one forum – namely a second LTL chapter 11 case that was filed on April 4, 2023. LTL asserts that the new funding arrangement and second chapter 11 case satisfies the Third Circuit's concerns and is filed with plan support agreements from more than 60,000 talc claimants. The litigation may continue as the official tort claimants' committee from the first chapter 11 case, however, has signaled opposition.

B. Texas Two Step Previously Survived in face of motion to dismiss for bad faith

In re LTL Management was not the first Texas Two Step case to face a motion to dismiss for bad faith. Applying what the Bankruptcy Court for the District of New Jersey described as a "much more stringent standard for dismissal of a case for lacking good faith," the Bankruptcy Court for the Western District of North Carolina (which is in the Fourth Circuit) previously denied a motion to dismiss a Texas Two Step filing for bad faith in *In re Bestwall LLC*, 605 B.R. 43 (Bankr. W.D.N.C. 2019).

Even though all four Texas Two-Step cases used Texas law to accomplish their divisive mergers, all but one filed their bankruptcy cases in the Bankruptcy Court for the Western District of North Carolina, despite minimal contacts with that state. The popularity of this forum is likely due to the Fourth Circuit's standard for bad faith dismissal of a chapter 11 filing. In fact, the Fourth Circuit's dismissal standard has been described as "one of the most stringent articulated by the federal courts." *In re Dunes Hotel Assoc.*, 188 B.R. 162, 168 (Bankr. D.S.C. 1995). In order to dismiss a chapter 11 case for bad faith in the Fourth Circuit, a court must find that the chapter 11 case is both (a) objectively futile and (b) filed in subjective bad faith. *Carolin Corp. v. Miller*, 886 F.2d 693, 700-01 (4th Cir. 1989).

Indeed, the official committee of product liability claimants in *In re Bestwall* failed in its efforts to achieve dismissal of the chapter 11 filing because of the Fourth Circuit's stringent standard. In *In re Bestwall*, BestWall Gypsum Co. ("Old Bestwall") had been previously purchased by Georgia-Pacific, LLC ("Old GP"). Old Bestwall, which manufactured and sold certain asbestos containing products, continued operations after its purchase by Old GP and amassed approximately 64,000 asbestos related tort claims. Then, during a 2017 corporate restructuring, Old GP was dissolved, and Old Bestwall was merged into two new entities through a Texas divisive merger: (1) Bestwall, LLC ("Bestwall") whose sole responsibility is the assumption, management, and defense of Old Bestwall's asbestos-related litigation claims, and (2) Georgia-Pacific LLC ("New GP"), which continues Old GP's manufacture and sale of tissue, pulp, paper, packaging and building products. In addition to asbestos related litigation, Bestwall also received a funding agreement from New GP, wherein New GP agreed to provide funding for all costs of the chapter 11 case and funding for a section 524(g) asbestos trust ("GP Funding Agreement"). Bestwall then completed the Texas Two Step by filing for relief under chapter 11 of the Bankruptcy Code in the Bankruptcy Court for the Western District of North Carolina.

When presented with a motion to dismiss for bad faith filing, the bankruptcy court looked first to whether Bestwall's bankruptcy case was "objectively futile." Under Fourth Circuit law, the objective futility inquiry should "concentrate on assessing whether there is no going concern to preserve . . . and . . . no hope of rehabilitation, except according to the debtor's 'terminal euphoria.'" Contrary to the Third Circuit's view of the need for distress, the bankruptcy court, applying the Fourth Circuit standard, instead lauded Bestwall's financial wherewithal finding that the objective futility test focuses on the debtor's financial stability and the means to a realistic rehabilitation.

With this background, the bankruptcy court found that attempting to resolve asbestos claims through Section 524(g) alone is a valid reorganizational purpose, and filing for chapter 11, especially in the context of an asbestos or mass tort case, need not be due to insolvency. Because Bestwall had substantial assets, including the GP Funding Agreement, the bankruptcy court determined that Bestwall would be able to acquire the funds necessary to fund an asbestos trust under Section 524(g) of the US Bankruptcy Code. Therefore, the court found that Bestwall had the objective ability to meet its obligations and reorganize as a going concern. Because the Court concluded Bestwall had the resources with which to reorganize, it determined the chapter 11 filing was not objectively futile and, under the conjunctive two part test, did not need to address whether the case was filed in subjective bad faith.

C. Competing standards

As demonstrated, the Fourth Circuit's standard applied in *In re Bestwall* stands nearly in direct contrast with the Third Circuit's ruling in *In re LTL Management*. Under Fourth Circuit law, the presence of the GP Funding Agreement ensured Bestwall's ability to reorganize and create an asbestos trust. The bankruptcy court determined this alone was a valid bankruptcy purpose. In *In re LTL Management*, on the other hand, the Third Circuit also determined that the LTL Funding Agreement rendered LTL financially stable. However, according to the Third Circuit, the LTL Funding Agreement doomed LTL's bankruptcy filing because the absence of financial distress meant the chapter 11 case was filed without a proper bankruptcy purpose.

The opposing standards in these cases stem from fundamentally different views of the accessibility of protections afforded by the US Bankruptcy Code. According to the Fourth Circuit Court of Appeals,

> "it is better to risk proceeding with a wrongly motivated invocation of Chapter 11 protections whose futility is not immediately manifest than to risk cutting off even a remote chance that that a reorganization effort so motivated might nevertheless yield a successful rehabilitation."

Carolin, 886 F.2d at 701. Under this view, even a "wrongly motivated" rehabilitation effort is to be encouraged if it is at all feasible. On the other hand, the Third Circuit finds its standard rooted in equitable limitations, sanctioning the use of bankruptcy to disrupt the system of individual creditor remedies only where justified to protect recoveries for those creditors. *In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 129–129 (3d Cir. 2004).

This contrast will likely lead continued litigation and venue skirmishes throughout Texas Two Step cases, and interested parties, therefore, should keep apprised of further developments in this evolving area. Notably, in light of the Third Circuit's decision in *In re LTL Management*, Texas Two Step case law may effect a larger swath of entities than those considering the chapter 11 process to mitigate mass tort litigation risk. All parties to a chapter 11, particularly in the Third Circuit, must consider whether a commercial debtor is in "financial distress" and filed its petition for a proper purpose. Otherwise, any debtor may face a motion to dismiss for bad faith filing. Stay tuned for further developments in this fast moving area, including possibly in the United States Supreme Court and in LTL's second chapter 11 case.

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