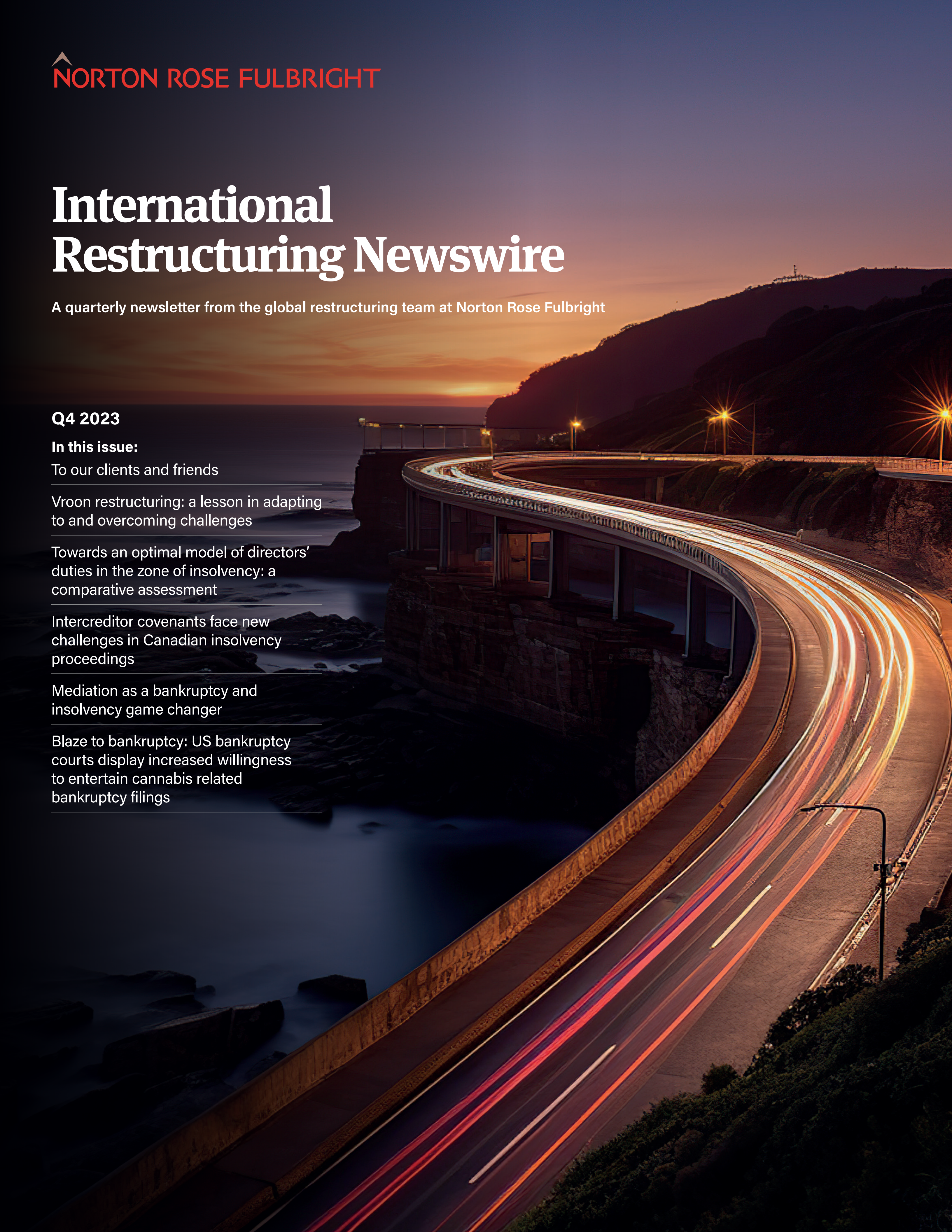

NORTON ROSE FULBRIGHT

International Restructuring Newswire

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

Q4 2023

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To our clients and friends

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International Restructuring Newswire

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International Restructuring Newswire

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To our clients and friends:

Welcome to our fourth quarter issue of Norton Rose Fulbright's *International Restructuring Newswire*. We again draw on our global team of lawyers to address some of the key issues facing restructuring professionals.

The recent restructuring of the Dutch shipping group Vroon demonstrates vividly the challenges facing practitioners dealing with the complexities of cross-border situations. The restructuring also demonstrates that with creativity and perseverance, practitioners can use the tools that exist to put together deals that preserve businesses and maximize recoveries for creditors and other stakeholders. Here, we take an in-depth look at the successful Vroon restructuring and how the parties used both a Dutch WHOA and an English scheme of arrangement to get the deal done.

In this issue, we also hear from our practitioners in Canada on the challenges to intercreditor covenants in insolvency proceedings and in the US on how cannabis companies fare in the US bankruptcy courts. And we take a global view on two increasingly critical issues: the use of mediation in restructurings and risk to directors of companies on the cusp of insolvency.

Good reading,

Howard Seife
Global Co-Head of Restructuring
New York

Scott Atkins
Global Co-Head of Restructuring
Sydney

In the news

The Public Listed Companies (PLC) Transformation Programme

August 7, 2023

Meiyen Tan (Singapore) was a speaker at "Rethinking Balance Sheets: Addressing Performance Decline vide Restructuring" hosted by Bursa Malaysia, the stock exchange of Malaysia, one of the largest bourses in ASEAN. Meiyen spoke about the increased importance of private credit in the region and the available tools in Singapore to facilitate new money investments in distressed businesses.

Banking & Financial Services Law Association

September 4, 2023

Lee Pascoe (Melbourne) participated as a panellist at the annual conference where she spoke on "Crypto Collapses – a deep dive into recoveries" and spoke particularly on the restructuring of cryptocurrency businesses in Australia and Singapore.

INSOL Future Leaders Programme

September 7, 2023

Howard Seife (New York) addressed Latin American participants in INSOL International's 3rd Future Leaders Programme and discussed what it is to be a leader in the field. The program is conducted in 15 countries and has been flagged as one of INSOL's great initiatives for younger practitioners.

INSOL Tokyo 2023

September 11–13, 2023

We were a proud sponsor of INSOL International's annual conference in Tokyo in September. Over 20 of the firm's global restructuring team attended the conference. Scott Atkins (Sydney), in his role as President of INSOL, provided opening and closing remarks. INSOL is the the premier insolvency and restructuring global association consisting of restructuring professionals, financiers and academics across the world.

INSOL Focus Webinar

September 21, 2023

Noel McCoy (Sydney) participated in a webinar with INSOL International discussing navigating cross-border insolvencies and the Courts' jurisdiction to wind-up entities and provide assistance to officeholders.

Canadian Bar Association Insolvency Law Conference

September 29, 2023

Samuel Perron (Québec) co-chaired the 17th Annual CBA National Insolvency Law Conference in Montreal. Al Hounsell (Toronto) spoke on a panel on artificial intelligence.

Netherlands Bar Association – Diversity Day

October 2, 2023

Prof. Omar Salah (Amsterdam) spoke at Diversity Day hosted by the Netherlands Bar Association (*Nederlandse Orde van Advocaten*). Omar shared his views and the efforts of the firm on diversity, equity & inclusion in the legal profession in the Netherlands.

Lianhe Zaobao 联合早报

October 10, 2023

Meiyen Tan (Singapore) explained to Lianhe Zaobao 联合早报, one of Singapore's leading Chinese dailies, Singapore's latest restructuring trend and shared how corporates in Southeast Asia are raising capital and facilitating expansion plans in alternative ways.

INSOL Europe Annual Conference

October 12–15, 2023

Omar Salah (Amsterdam) participated in INSOL Europe's annual conference in Amsterdam. The conference was titled "Navigating Insolvency with Trust and Integrity."

Law Council of Australia, Insolvency & Restructuring Committee

October 13, 2023

Natasha Toholka (Melbourne) was a panellist at Law Council of Australia's annual conference workshop, speaking to recent decisions concerning deeds of company arrangement. Natasha has been appointed chair of the Insolvency & Restructuring Committee for 2024-2025, being the peak insolvency and restructuring body for Australian lawyers.

David Goldman (Sydney) also spoke at the conference where he delivered a talk on recent cases dealing with insolvency practitioner duties.

International Bar Association

October 30, 2023

Lee Pascoe (Melbourne) is participating as a panellist at the annual conference in Paris and will speak on "Decrypting Cryptocurrencies in bankruptcies." Lee will continue in her role as Virtual Assets Officer of the IBA Insolvency Committee into 2024.

Dutch Restructuring Association

November 2, 2023
Omar Salah (Amsterdam) was invited to speak on a panel at the annual conference of the Dutch Restructuring Association. The panel topic is "The Big Ones," which will discuss the big restructurings under the WHOA (also known as the 'Dutch Scheme') so far. Omar has worked on some of the largest WHOA restructurings so far, including the WHOA proceedings of Royal IHC and Vroon Group.

California Society of Municipal Analysists Fall Conference

November 3, 2023
Rebecca Winthrop (Los Angeles) will speak on hot topics for municipal analysists at the fall conference of the California Society of Municipal Analysists in Napa, California

42nd Annual Jay L. Westbrook Bankruptcy Conference

November 15–17, 2022
Ryan Manns (Dallas) will moderate a panel at the annual Jay L.

Westbrook bankruptcy conference in Austin, Texas. His panel of distinguished judges will discuss trends in their cases and share valuable insights from the bench.

INSOL International – ESG in Restructuring

Prof. Omar Salah and Tamara Ubink (Amsterdam) contributed the Netherlands chapter in INSOL's guide on *ESG in Restructuring*. This new publication canvases the policy motivations of ESG and insolvency and restructuring law and practice, and considers the regulatory standards, soft law frameworks and practices concerning key ESG issues outlined by esteemed practitioners and academics in 31 jurisdictions. The full guide can be viewed in INSOL's Technical Library.

Australian Restructuring, Insolvency and Turnaround Association (ARITA)

Sonja Marsic, Jeremy Moller and Charles Nugent-Young (Sydney) published an article in the September 1, 2023 edition of *ARITA Journal* on the expansion of Australia's anti-money laundering and counter-terrorism financing regime and its importance for insolvency practitioners. Noel McCoy (Sydney) also published an article on strategies for liquidators to preserve voidable transaction claims.

International Corporate Rescue

Scott Atkins and Dr Kai Luck (Sydney) published an article in the September 28, 2023 issue of *International Corporate Rescue* on policy and regulatory advances in informal workout and MSE processes, including a 'deeper dive' into the importance and contextual place of these matters as part of an efficient, best practice insolvency system.

Government evaluation of the Dutch WHOA

Prof. Omar Salah (Amsterdam) was consulted as part of an expert group set up by the Dutch government to evaluate the WHOA (also known as the 'Dutch Scheme'), which entered into force on January 1, 2021. The Dutch government committed to a government evaluation after three years of its enactment and Omar was invited to share his experience in various large Dutch WHOA proceedings.

UNSW LLM Insolvency Course

Dr David Goldman (Sydney) completed convening and teaching the masters course "Corporate Insolvency" for another year at UNSW Law School, where he is an Adjunct Associate Professor.

Dutch Law Review on Financing, Security Rights & Insolvency Law

Prof. Omar (Amsterdam) co-authored an article with Joel Lozeman on the role of the restructuring expert and the observer in the *Dutch Law Review on Financing, Security Rights & Insolvency Law* – "Tijdschrift Financiering, Zekerheden en Insolventierechtpraktijk (FIP)". Omar and Joel describe the role of these court-appointed insolvency practitioners under the Dutch WHOA and make recommendations for potential amendments to the Dutch WHOA (see FIP 2023/208).

INSOL WORLD

Prof. Omar Salah (Amsterdam) was interviewed by *INSOL World* – "In Conversation: Restructuring of the Vroon Group". The restructuring of the Vroon Group was the first-ever restructuring under the Dutch WHOA with a parallel English scheme of arrangement. Omar shared his experiences working on one of the largest restructurings under the WHOA so far.

Global Restructuring Review

The *Global Restructuring Review* featured Omar Salah (Amsterdam) on the international restructuring of the Steinhoff Group. Omar shared his views on this restructuring under the Dutch WHOA in an article titled "Steinhoff WHOA plan confirmed as shareholder dissent rejected."

JOR Law Review

Prof. Omar Salah (Amsterdam) wrote two academic case notes on the Steinhoff Restructuring. The annotations are for JOR with case law reference JOR 2023/223 and JOR 2023/224. JOR is a leading law review on insolvency law and corporate law in the Netherlands.

Vroon restructuring: a lesson in adapting to and overcoming challenges

James Stonebridge, Prof. Omar Salah, Jade Porter and Bas van Hooijdonk

The restructuring of the Vroon group after years of negotiation and challenges serves as a lesson in how to adapt to changing conditions and to overcome the same to achieve a successful restructuring. It took years of negotiation for stakeholders to negotiate a proposed restructuring with market conditions ever changing in the meantime. However, once a proposed restructuring had been agreed in principle, challenges relating to its implementation remained. Such challenges included: pressure from lender enforcements, a non-consenting shareholder, multiple bilateral facility agreements and a non-consenting creditor. These challenges were overcome by using a parallel process of a Dutch WHOA and an English scheme of arrangement which was the first of its kind.

Background

The Dutch shipping group, Vroon, faced pressure on liquidity since 2016 due to its debt obligations as well as challenges in the shipping industry generally. The group's debt profile was complex with 28 different financing arrangements and 14 different lenders (as at the time the claim form for the scheme was submitted) with different security packages. Furthermore, the restructuring covered around a dozen jurisdictions, which added cross-border challenges that had to be addressed. In response to the initial challenges the group faced, in November 2018, the group entered into an English law framework agreement. Under the framework agreement there was a uniform maturity date of 31 March 2021, as well as cross-guarantees and new security for the benefit of all framework agreement lenders.

By the fourth quarter of 2019, there were breaches of certain covenants under the framework agreement. The Covid-19 pandemic also exacerbated the pressures on the group with global shipping demand impacted and operational challenges and costs.

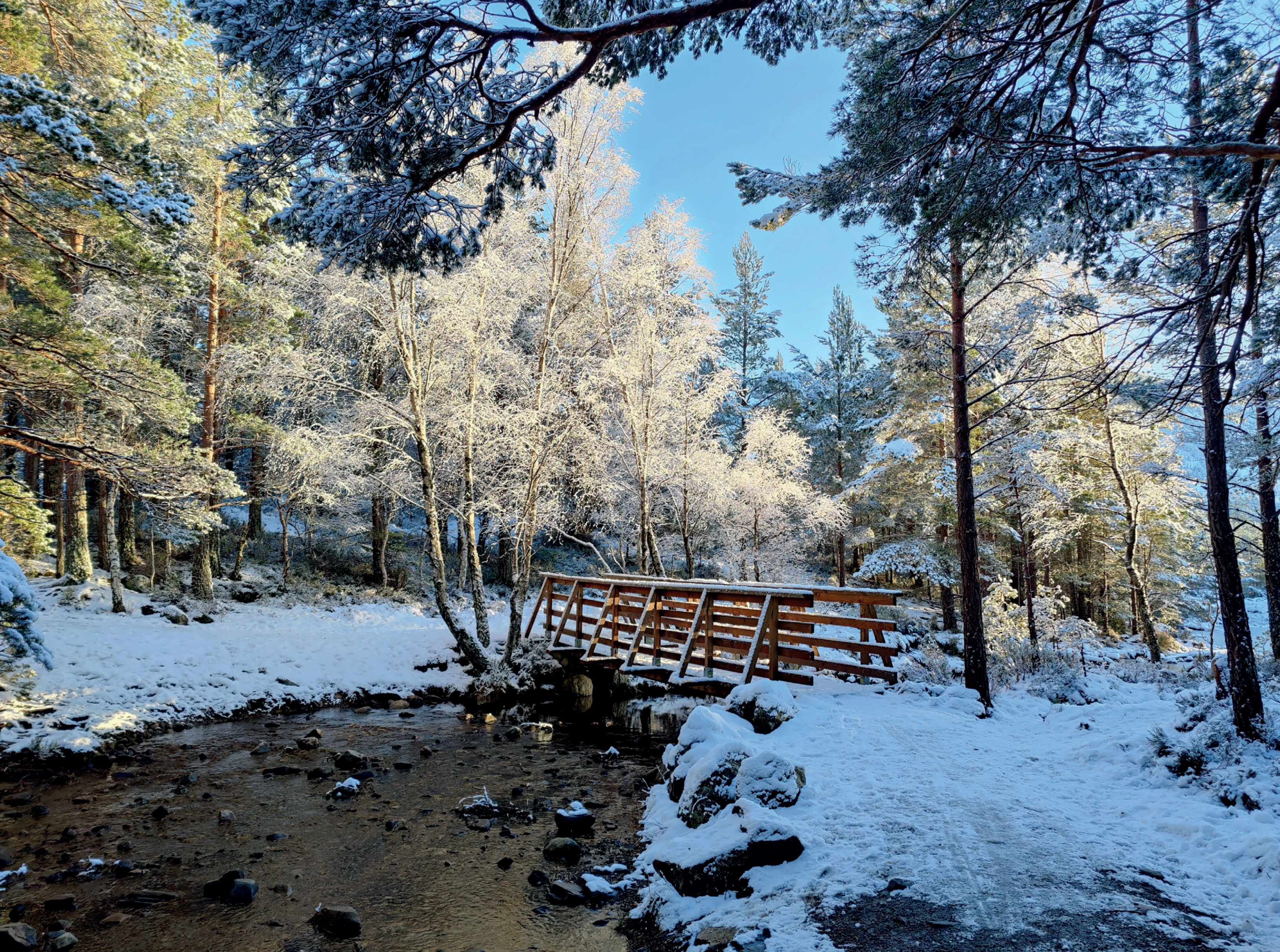
On 30 June 2020, the Vroon group defaulted under the framework agreement. On 31 March 2021, being the final maturity date under the framework agreement, the amounts outstanding were not repaid triggering a global acceleration event. The stakeholders undertook complex and lengthy negotiations for a proposed restructuring. Whilst this was ongoing there was a de facto standstill amongst the lenders.

Prior to the restructuring, the parent of the group was Vroon Group B.V. which was ultimately owned by Mr F.D. Vroon (the **Shareholder**). Immediately below Vroon Group B.V. sat an intermediate holding company, Lamo Holding B.V. (the **Company**). The Company is the holding company for the other group companies.

The proposed restructuring

The proposed restructuring contained an equity component and multiple debt components. The equity component consisted of a partial debt-for-equity-swap, whereby the Company's shares were transferred to a Dutch foundation (*stichting administratiekantoor*, **STAK**). The STAK is in essence a Dutch orphan structure. Subsequently, the STAK would issue depositary receipts (*certificaten*) to the lenders and the Shareholder, which made them the *de facto* owners of the Vroon group. Similarly, the debt component was split between facilities/vessels/lenders which intended to remain going forward and those that would exit in the short term. There were also separate deals for lenders/facilities that were either outside the framework agreement, were expected to be repaid in full or that had particular strategic importance to the ongoing operations of the business. The different aspects were included in a bespoke restructuring deal.

As such creditors were split into three categories (with some creditors falling in more than one of the categories listed below):



1. "NewCo Creditors" – these creditors and the vessels they financed were those that intended to remain long term for the ongoing business. Their debt needed to be right-sized and as such these creditors agreed to release their claims under their relevant "bilateral" or "semi-bilateral" facility agreement(s). In exchange, these lenders received a written-down participation in a centralised syndicated loan facility at the level of the Company financing the "NewCo Vessels" (we will come back to the complexity of the financing structure at Challenge 2);
2. "Exiting Creditors" - these creditors and the vessels they financed were those that intended to exit in the short term. As such they agreed to their vessels being sold in a controlled process over an 18-month period and having their claims against the Vroon group settled against the proceeds of such sale; and
3. "Excluded Creditors" – these creditors would receive separate negotiated deals due to the unique nature of their financing arrangements.

NewCo Creditors and Exiting Creditors, in exchange for their write-downs or estimated deficiencies in respect of the sale of the vessels (as the case may be), were also allocated depositary receipts in the Company and a share of cash in the group.

The challenges and solutions

Challenge 1: pressure from lender enforcements

In the second half of 2022, certain lenders became impatient and took enforcement action over vessels. This could have started a chain reaction amongst lenders to take similar action which could have pushed the group into bankruptcy. However, a WHOA (also known as the 'Dutch scheme) was launched which, whilst also addressing other implementation issues as detailed at challenge 3 below, provided a group-wide stay against enforcement. The stay was granted by the court on an *ex parte* basis. The stay granted the group breathing space in order to continue trading and implement

the proposed restructuring. The reach of such a stay (in theory) was potentially challengeable but no such challenge came. This may be due to institutions' reluctance to breach court orders (particularly given the international nature of such institutions) and may also be due to the short distance to the finish line of the restructuring at the time the WHOA was launched. It is worth noting that the stay on enforcement under the WHOA complemented the dual process as the English scheme of arrangement does not have the ability to provide such a stay against enforcement by a secured creditor.

Challenge 2: multiple bilateral facility agreements with one non-consenting scheme creditor

Another challenge in the implementation of this restructuring was that the financing structure to be restructured consisted of a number of "bilateral" or "semi-bilateral" facility agreements (the semi-bilateral facility agreements being so called "club deals") with different lenders, different borrowers and different security packages. As such the use of a scheme of arrangement or restructuring plan was not obvious or simple. To be able to use a scheme of arrangement to compromise the claims of one non-consenting lender, a deed of contribution was entered into prior to the convening hearing in favour of the individual borrowers under the facility agreements to prevent "ricochet claims" with the Company agreeing with each debtor subsidiary that in the event of the debtor making a payment under its loan, the Scheme Company will contribute half of that payment.

The scheme was therefore convened with two classes: Exiting Creditors and NewCo Creditors (as detailed above). There was a full turn out at the scheme meetings with only one creditor opposing (they were present in each class). The opposing creditor did not however turn up or seek to object at the sanction hearing and as such Mr Justice Leech sanctioned the scheme on 26 May 2023 and the opposing creditor was crammed.

Challenge 3: non-consenting Shareholder and WHOA creditor

Another major challenge was that the Shareholder was not supportive of the deal. Shareholder support was required to transfer consensually the shares in the Company to the STAK. However, as this was not forthcoming, a court-led restructuring process in the form of the WHOA was required to implement the debt-for-equity swap. In addition to opposing the WHOA, the Shareholder initiated unsuccessful proceedings before the Dutch Enterprise Chamber to hinder the restructuring process – this was the first time that parallel WHOA and Dutch Enterprise Chamber proceedings were initiated in the Netherlands. Also, a creditor opposed the final WHOA plan.

The Shareholder objected to the WHOA on the grounds that there was no fair distribution of the value to be realised under the restructuring plan. According to Dutch law, a restructuring plan can only be sanctioned if the value available under the restructuring plan is distributed fairly and in accordance with the statutory ranking of claims respecting the absolute-priority-rule. The Shareholder argued that the debt amount was inflated to distribute to the lenders more under the plan than they were entitled to. Furthermore, the Shareholder argued that the value available for distribution under the plan was much higher than presented by the debtor under the plan, implying surplus value available for distribution to the Shareholder. The Dutch court, however, was not convinced by these arguments and accepted the valuation used by the appraiser engaged by the group as well as the calculation of the total amount of debt owed to the lenders as presented by the group.

Alongside the Shareholder, an unsecured creditor also objected on the grounds that it was not given sufficient time to consider the contents of the restructuring plan. They also argued that losing a certain guarantee impacted the terms of one of its shipping insurance contracts. The Dutch court was not convinced that a longer voting period would have led to a different outcome of the vote and stated that the creditor should have discussed the impact of losing the guarantee with their insurer prior to the hearing, which they failed to do. Accordingly, the Dutch court sanctioned the WHOA.

Whilst the dual process of the WHOA and the scheme had many benefits, it also provided the Shareholder with a second forum in the English court in which to object to the restructuring. The Company argued that the Shareholder (who was not a scheme creditor) should not get "a second bite of the cherry" and argued that the Shareholder's real objection was not to the scheme but rather to the WHOA and the transfer of shares in the Company to the STAK. However, the Shareholder argued that the mechanism for the issuance of the depositary receipts was the implementation agreement (appended to the Explanatory Statement for the scheme) and not the WHOA. Mr Justice Leech did not decide on this point but rather made a case management decision to re-list the sanction hearing for two further days to give the Shareholder a full opportunity to be heard in relation to the fairness of the scheme. It is worth noting that Mr Justice Leech stated that if the Dutch court had handed down its decision before the

first hearing on 16 May 2023, he would have refused to give the Shareholder an opportunity to challenge the Company's evidence in relation to the comparator (e.g. insolvent liquidation or solvent wind down) because they would have in essence been attempting to reargue valuation issues which the Dutch court had already decided against them. On the other side of the sea, the Dutch court waited to hand down its final decision as well, seemingly pending the outcome before the English court. In this parallel procedure it seemed that both courts were hesitant to issue the first court order and were waiting for the other court to provide its final decision. Eventually, the Dutch court went first and the English court handed down its final judgment an hour after the Dutch court sanctioned the WHOA plan.

Whilst Mr Justice Leech was ultimately satisfied that the insolvent liquidation of the group (rather than a solvent wind down) was the correct comparator, he also noted that even if there had been significant doubt in his mind that this was the relevant comparator, he would have still sanctioned the scheme for the same reasons as Mann J in *Bluebrook* that "it is not a legitimate or sensible use of the Court's powers to force the parties to enter into further negotiations (especially after they have been negotiating for seven years)".

Ultimately both the scheme and the WHOA were sanctioned on 26 May 2023 and enabled the restructuring to be implemented shortly thereafter.

As such the true parallel nature of the scheme and the WHOA and the interconditionality between the two led to additional time in achieving the restructuring but ultimately provided a solution to a complex situation.

Conclusion

The Vroon restructuring was the first-of-its-kind restructuring involving multiple complexities, including the first parallel Dutch WHOA and English scheme of arrangement. It has shown that different restructuring tools can be adapted such that many challenges can be overcome by using creative ways and parallel processes in different jurisdictions.

James Stonebridge is a partner in our London office and EMEA Co-Head of Restructuring. Prof. Omar Salah is a partner in our Amsterdam office and Professor of Global Finance & Restructuring Law at Tilburg University. Jade Porter and Bas van Hooijdonk are associates in our London and Amsterdam offices, respectively. All are members of the firm's global restructuring group.

Towards an optimal model of directors' duties in the zone of insolvency: a comparative assessment

Aurelio Gurrea-Martinez

Introduction

When a company becomes insolvent but it is not yet subject to a formal insolvency proceeding, the shareholders –or the directors acting on their behalf– may engage, even in good faith, in various forms of behaviour that can divert or destroy value at the expense of the creditors. For this reason, most jurisdictions around the world provide a variety of legal strategies to respond to this form of shareholder opportunism. One of these strategies is the imposition of special directors' duties in the "zone of insolvency." One size does not fit all, however. Regulators and legislators should consider the country and firm specific factors when modeling the legal structures for the zone of insolvency.

Regulatory models of directors' duties in the zone of insolvency

In a recent article, I analysed the primary regulatory models of directors' duties in the zone of insolvency observed internationally. From a sample of more than 25 jurisdictions from Asia, Australia, Europe, Latin America, Africa, and North America, I distinguish six regulatory models of directors' duties in the zone of insolvency: (i) the imposition of a duty to initiate insolvency proceedings, generally found in Europe and a few other jurisdictions around the world; (ii) the imposition of a duty to recapitalise or liquidate the company, typically existing in Europe and Latin America; (iii) the imposition of duties towards the company's creditors, including the duty to minimise losses for the creditors indirectly imposed by the wrongful trading provisions in the United Kingdom; (iv) the imposition of a duty to prevent the company from incurring new debts, existing in countries like Australia and South Africa; (v) the imposition of a duty to prevent the company from incurring new debts that cannot be paid in full, existing in Singapore and New Zealand; and (vi) the imposition of a duty to keep maximising the value of the firm, found in jurisdictions such as Canada and the United States. Moreover, it should be taking into consideration that, in addition to these special duties generally imposed in the zone of insolvency, corporate directors can be subject to other creditor-related duties. For instance, in the United Kingdom, Australia and Singapore, corporate directors might be required to take into account the interests of the creditors under certain circumstances. In New Zealand, the directors of solvent firms can be liable for 'reckless decision' ultimately harming the creditors.

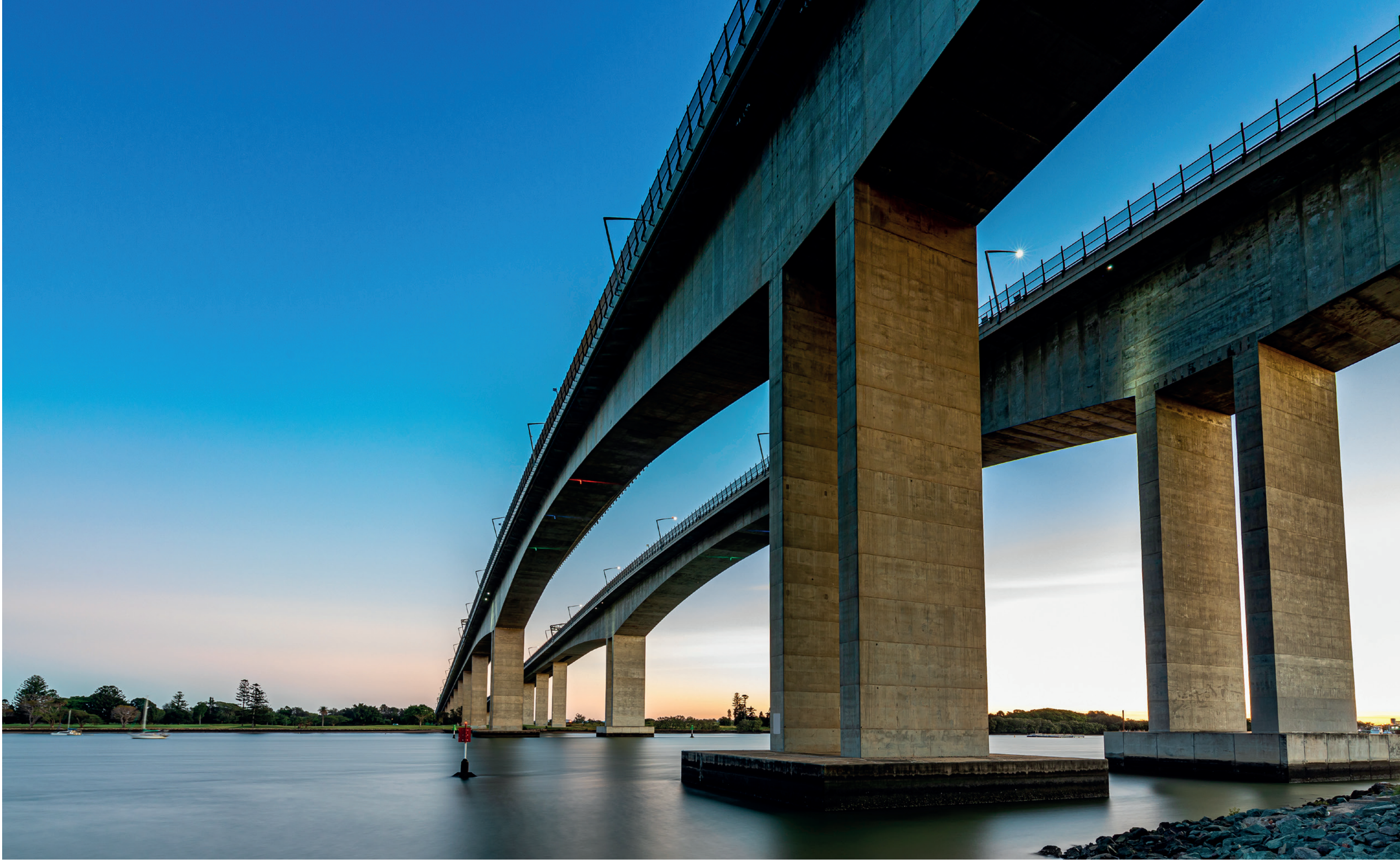
After analysing the features, advantages and weaknesses of each regulatory model of directors' duties in the zone of insolvency, my paper argues that the 'optimal' approach depends on a variety of country-specific and firm-specific factors, including divergences in corporate ownership structures, firm size, debt structures, level of financial development, efficiency of the insolvency framework, and sophistication of the judiciary.

Factors affecting the desirability of a regulatory model of directors' duties in the zone of insolvency

Corporate ownership structures

In micro and small enterprises (**MSEs**) as well as large privately owned firms, which are the types of firms found in most countries around the world, there is a greater alignment of incentives between directors and shareholders. Therefore, in the event of insolvency, the directors might be more willing to favour the interests of the shareholders *even if* it is at the expense of the creditors. As a result, a more interventionist approach to protect creditors, such as the duty to initiate insolvency proceedings, may make more sense. Otherwise, even if the directors do not ultimately harm the creditors once the company becomes insolvent, the existence of this *risk* may encourage lenders to be more reluctant to extend credit, leading to an undesirable increase in the cost of debt or to most stringent conditions in their debt covenants.

By contrast, in companies with dispersed ownership structures, generally found in the United Kingdom and the United States, a more flexible approach for the regulation of directors' duties in the zone of insolvency may be more justified. Therefore, the duty to maximise value and to keep acting in the best interest of the corporation (US/Canadian approach) or a duty to take steps to minimise potential losses for the creditors (UK approach) can make more sense.



In companies with dispersed ownership structures, the directors will be less influenced by the shareholders. Therefore, by being in a better position to preserve their independence, they will have incentives to make value-maximising decisions even if, in the event of insolvency, these decisions do not always please the shareholders. If the shareholders are unhappy with these decisions, the existence of the exacerbated collective action problems existing in companies with dispersed ownership structures will prevent them from quickly removing the directors. Thus, while the separation of management and control is the primary source of agency problems in the context of solvent firms with dispersed ownership structures, it can actually be desirable for the creditors when a company becomes insolvent.

Debt structures

In companies with simple debt structures, as generally occurs in MSEs and large companies in countries with bank-based financial systems, creditors do not face significant coordination costs. Therefore, reaching an out-of-court agreement between debtors and creditors will be more feasible. As a result, since insolvency proceedings might not always be needed, the duty to initiate insolvency proceedings will be less justified. By contrast, in companies with dispersed debt structures, the existence of holdout problems and collective action problems will make certain insolvency provisions – such as a moratorium and the existence of majority rule or even cramdown provisions for the approval of reorganization plans – more needed. Therefore, forcing companies to initiate insolvency proceedings may be more justified in the type of companies with dispersed debt structures generally found in the United States and, to a lesser extent, in other financial centers such as the United Kingdom, Hong Kong and Singapore.

Sophistication of the judiciary

In countries with sophisticated courts, such as the United States, the United Kingdom and Singapore, the involvement of courts in insolvency proceedings is generally justified. Unfortunately, many countries around the world, and particularly emerging economies, might not have an efficient, independent and predictable judiciary comprising experienced, competent and well-equipped judges. In this latter scenario, it would make sense to reduce the involvement of judges in insolvency proceedings. Therefore, those directors' duties in the zone of insolvency requiring a heavy involvement of judges, such as the duty to take steps to minimise losses for the creditors existing under the wrongful trading provisions found in the United Kingdom, should be avoided. In this jurisdiction, the use of relatively clear and bright line rules, rather than broad standards, should be favoured. As a result, a duty to initiate insolvency

proceedings may be more desirable in countries without sophisticated courts.

Efficiency of the insolvency system

Many countries, and particularly emerging economies, do not have efficient insolvency proceedings. These inefficiencies can be due to the existence of inefficient laws, inefficient judicial systems, or both. Regardless of the reason, the commencement of insolvency proceedings can be value-destroying for both debtors and creditors. As a result, imposing a duty to initiate insolvency proceedings does not seem a desirable policy in countries with inefficient insolvency frameworks. In countries where insolvency proceedings can serve as an effective and efficient tools that can help debtors and creditors, however, the imposition of a duty to initiate insolvency proceedings can be more justified.

Level of financial development

In countries with developed financial systems, viable companies facing financial trouble may have more chances to obtain new financing. Unfortunately, in many countries around the world, and particularly in emerging economies, companies (and especially MSEs) face significant problems having access to finance even when they do not face a situation of insolvency. Hence, adopting a solution that does not credibly solve the risk of shareholder opportunism in the zone of insolvency can exacerbate the problems associated with the lack of finance often existing in these countries. As a result, in these latter jurisdictions, more interventionist approaches, such as the duty to initiate insolvency proceedings, may make more sense. However, since many companies with underdeveloped financial systems also have inefficient insolvency frameworks, forcing companies to initiate an insolvency proceeding may end up doing more harm than good for the creditors. Therefore, instead of a duty to initiate insolvency proceedings, it would probably make more sense to impose a duty to prevent the company from incurring new debts if the directors know, or ought to have known, that the company will not be able to repay the new debts in full.

Conclusion

Unfortunately for regulators and policymakers, most countries have mixed features. Therefore, designing a desirable model of directors' duties in the zone of insolvency is not that easy. For example, in many countries, and especially in emerging economies, the insolvency system is not very efficient, companies face significant problems having access to finance, the judiciary is not highly sophisticated, and most businesses are MSEs or large privately owned firms.

In those situations, the duty to maximise the value of the firm should be eschewed due to the detrimental effects on the cost of credit that the higher risk of shareholder opportunism associated with this regulatory model may generate, especially in the context of MSEs and privately owned firms. Likewise, if courts are not very sophisticated, judging ex post the particular strategies that the directors adopted to minimise losses for the creditors does not seem a desirable option either. Finally, the imposition of a duty to initiate a value-destroying insolvency proceeding will probably do more harm than good for both debtors and creditors. As a result, in countries with these features, the adoption of other approaches, such as the duty to prevent the company from incurring new debts, can be a more desirable option, especially if it is implemented along with certain safeguards and exceptions, such as those existing in Australia and Singapore.

Regardless of the policy option eventually chosen in a particular jurisdiction or for a particular type of firm, regulators and policymakers need to aware that, when designing a regulatory framework for directors' duties in the zone of insolvency, they cannot just replicate the laws or approaches existing in other countries. In fact, comparing the pros and cons of different regulatory approaches of directors' duties in the zone of insolvency can also be useless, or at least misleading, if this analysis is conducted in a vacuum. Each country has its own features, and the desirability of a particular regulatory model of directors' duties – as well as any other aspect of the insolvency legislation– should be tailored to those features.

For a comprehensive analysis of the insolvency framework and the market and institutional environment existing in emerging economies and how insolvency law should be designed in these jurisdictions, see Aurelio Gurrea-Martinez, *Reinventing Insolvency Law in Emerging Economies* (Cambridge University Press, Forthcoming, January 2024).

Aurelio Gurrea-Martínez is Associate Professor of Law and Head of the Singapore Global Restructuring Initiative at Singapore Management University

Intercreditor covenants face new challenges in Canadian insolvency proceedings

Evan Cobb

An integral element of any multi-party debt structure is the Intercreditor Agreement. The most basic Intercreditor Agreement will establish the priority ranking of the creditors' claims and security.

Often the Intercreditor Agreement will also include a far more extensive list of rules agreed as between the creditors themselves on:

- permitted amendments to their respective credit documents;
- standstills on enforcement of security;
- rights to provide priority interim financing in an insolvency proceeding; or
- creditors' rights and obligations when voting upon, supporting, or opposing insolvent restructuring transactions.

Significant time will often be spent negotiating these terms.

Creditors take great comfort in the intercreditor terms they have negotiated at the outset of a transaction. Senior secured creditors will determine they have adequately preserved their ability to control the path of an insolvency or realization scenario without undue disturbance from a junior creditor. A junior creditor will be comfortable that they have negotiated for sufficient protections to ensure their recoveries are not unduly impaired or delayed by the preferred enforcement steps of the senior creditor. These creditors will price intercreditor risks accordingly in their financing offers.

Unlike other contracts in an insolvency context, the Intercreditor Agreement is a particularly useful tool because it is enforceable between the creditors themselves, and not primarily against the debtor that may be subject to a broad stay or moratorium.

Practitioners often assume these agreements will be unimpaired by an insolvency proceeding. However, at least one recent case from the Courts of Alberta creates material questions about the scope of reliance that can be placed on Intercreditor Agreements in Canadian insolvencies.

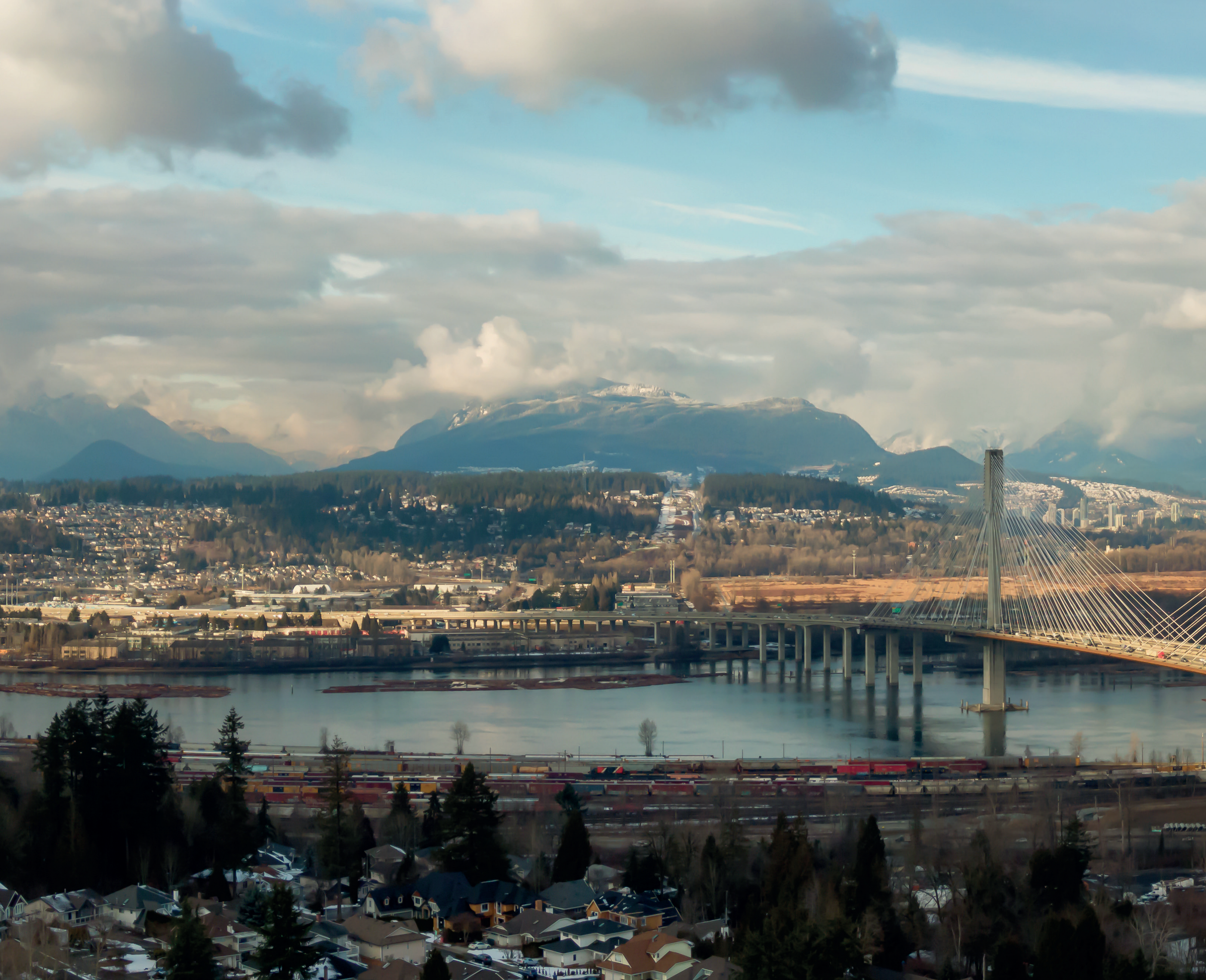
Dynamic Technologies Group Inc.

In the insolvency proceedings of *Dynamic Technologies Group Inc.* and its affiliates under Canada's *Companies' Creditors Arrangement Act* in the Alberta Court of Kings Bench, a dispute arose regarding the rights of one secured creditor to provide super-priority interim "DIP" financing in a Canadian insolvency proceeding. In Canada, DIP financing is a common feature used to fund a debtor's cash needs during an insolvency process and is most often subject to a super-priority court ordered charge required by the lender, which can be granted in the court's discretion.

At the commencement of the proceeding, the debtor companies required DIP financing. After what was described as diligent efforts on behalf of the debtors to identify an interim lender in the market, so as to enable the debtors to execute on their restructuring efforts, the only lender prepared to step forward with an interim financing term sheet was one of the incumbent secured creditors (the **DIP Lender**). The DIP Lender's term sheet required that the interim financing have the benefit of a super-priority court-ordered charge on the debtor's assets.

The pre-filing Intercreditor Agreement was a problem for this transaction. In the Intercreditor Agreement the DIP Lender agreed with one of the debtor's other secured lenders that any further advances in any form would be permitted but would be subordinated. The DIP Lender's interim financing proposal offered what the Intercreditor Agreement did not permit: further advances secured on a *super-priority* (not subordinated) basis.

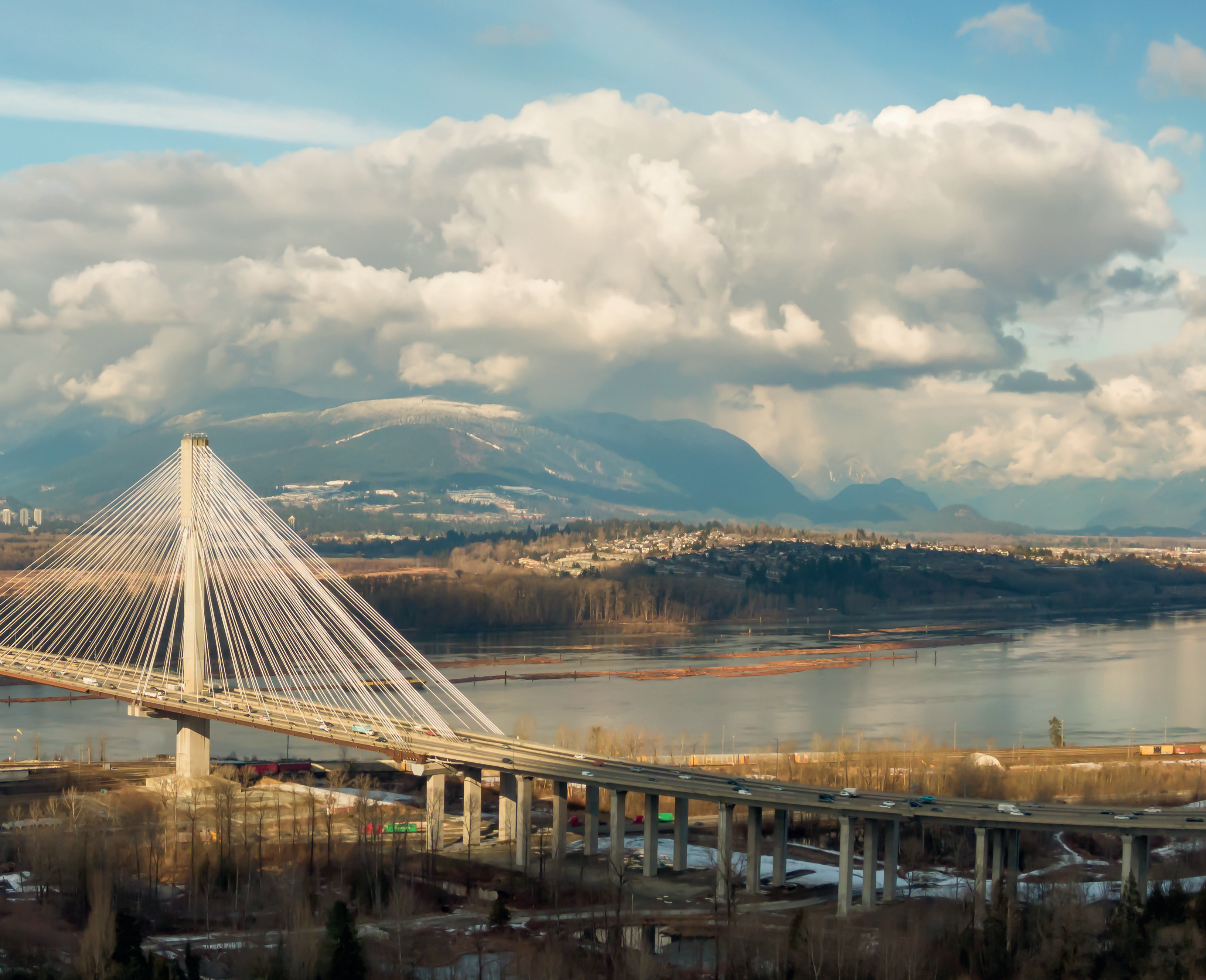
The objecting creditor took the position that the proposed super-priority interim financing was a breach of the Intercreditor Agreement, and should that interim financing be approved and implemented, any rights to sue the DIP Lender for breach of the Intercreditor Agreement should be preserved.



In the result, the Alberta Court approved the DIP Lender's interim financing proposal, granting a super-priority charge to secure that financing. The Alberta Court also extinguished any cause of action that the counterparty to the Intercreditor Agreement had as a result of this breach of the Intercreditor Agreement. In support of this decision, the Alberta Court found, among other things, that:

- The changing of the priority scheme (and here, the concurrent immunity from suit under the Intercreditor Agreement) was integral to the viability of the interim financing from the perspectives of both the lender and the debtor. Unless granted, the DIP Lender would have no reason to offer the interim financing, no reorganization would take place and a liquidation would be the likely result.
- The determination to grant this super-priority charge and insulate the DIP Lender from any liability under the Intercreditor Agreement was an exercise of the Alberta Court's discretion under the *Companies' Creditors Arrangement Act.*
- For public policy reasons, namely the avoidance of the economic and social cost of large business failure, the DIP Lender should be afforded special treatment in this context to facilitate the interim financing, including the immunity from any cause of action resulting from the breach of the Intercreditor Agreement.

The court acknowledged the arguments raised by the opposing creditor that the insolvency court should not affect or impair the intercreditor rights as between parties who are not debtors in the insolvency proceeding. However, the court found that in this particular case, the debtor was involved in



this relationship both as a party to the Intercreditor Agreement and as the recipient dependent upon the proposed interim financing. The same could be said for debtors in substantially all intercreditor arrangements that contain restrictions on super-priority interim financing.

Notably, Canadian insolvency statutes do not have an equivalent to Section 510(a) of the United States Bankruptcy Code, which provides that a subordination agreement is enforceable in a case under Chapter 11 of the United States Bankruptcy Code to the same extent that such agreement is enforceable under applicable non-bankruptcy law.

While the *Dynamic Technologies Group Inc.* decision is only a single decision from the insolvency court in a single Canadian jurisdiction, secured creditors in all Canadian jurisdictions should be aware of its potential implications.

Practical issues

Lenders should be aware of the potential limitations on their contractual intercreditor protections in a Canadian insolvency proceeding based on the reasoning in the *Dynamic Technologies* case. In particular, any intercreditor restrictions that have a practical effect of limiting or impairing the debtor's going concern restructuring options will be most susceptible to challenge.

The following types of common intercreditor restrictions immediately come to mind:

A. Restrictions on priming DIP financing:

As seen in the *Dynamic Technologies* case, even if a creditor has agreed it will not provide priming DIP financing, the court may create a path for the provision of that priming

DIP financing notwithstanding the intercreditor restrictions, if no other viable financing options are available to fund a restructuring.

This is a particularly difficult concern to remedy for two reasons.

First, one would expect a subordinate creditor seeking to provide DIP financing will in all cases take the position that they require a super-priority position for any DIP financing; or, at the very least, not a subordinated position behind substantial senior secured pre-filing debt. If the senior lender does not itself provide the DIP financing or does not find a friendly third party to do so, *Dynamic Technologies* suggests the door is open for the debtor and the subordinate creditor to avoid their Intercreditor Agreement restrictions and enter into a priority DIP financing arrangement in an effort to maintain a going concern restructuring. If that is the case, then the senior lenders who have bargained for DIP financing restrictions in their intercreditor arrangements can have, at best, a right of first refusal on any priority DIP financing before the restricted subordinate creditor has the right to proceed with its priority DIP financing proposal.

Second, it is not clear how these issues would be resolved in a circumstance where an existing first lien lender offers DIP financing sufficient to complete an expedited realization process, but a subordinate creditor who is contractually restricted from providing priority DIP financing offers more favourable terms and a more substantial DIP financing package. The DIP financing alternative from the first lien lender could be provided without breaching the Intercreditor Agreement. However, that DIP financing may not satisfy the debtor company's going concern restructuring objectives. In that context, can the debtor company and the subordinate lender pursue their DIP financing package that is more favourable to the debtor company's restructuring goals, notwithstanding the Intercreditor Agreement restrictions and the availability of at least some DIP financing from the senior lender that complies with the Intercreditor Agreement?

At this time, we can only identify that there are significant questions around the enforceability of DIP financing restrictions in Canadian Intercreditor Agreements.

B. Obligations to support restructuring transactions:

Intercreditor Agreements often impose obligations on subordinate lenders to proceed with restructuring transactions supported by the senior lender, and to not put forward any competing transactions.

These restrictions may be susceptible to a similar analysis as seen in the *Dynamic Technologies* case. The obligation of a subordinate creditor to support an expedited realization favoured by a senior lender may frustrate the going concern restructuring process the debtors seek to pursue. This is particularly true if there is a competing transaction available that better achieves a going concern outcome and ultimately (though perhaps more slowly) pays out the senior lenders. In this circumstance, the reasoning in *Dynamic Technologies* suggests a subordinate creditor may also be protected from opposing the senior creditor's preferred transaction in favour of the alternative going concern outcome.

C. Restrictions on the release of rights or encumbrances:

Particularly in the mining context, Intercreditor Agreements will often include restrictions preventing a lender from supporting a restructuring transaction that would have the effect of extinguishing another capital provider's interest in a stream, royalty or similar right.

These types of rights and encumbrances on assets could depress the sale price in an insolvency sale as substantial value would be extracted from the assets through future stream deliveries and royalty payments. To maximize the pool of potential going concern buyers and anticipated recoveries, the debtor and its creditors will have strong incentives to attempt to sell free and clear of any such stream, royalty or similar rights.

Suppose a going concern transaction can only be completed if such stream or royalty rights and interests are extinguished. In that case, based upon *Dynamic Technologies* there may be flexibility for a lender to support such a transaction that extinguishes the stream or royalty interest notwithstanding the lender's agreement to not do so in its Intercreditor Agreement. This would have a material impact on the stream or royalty holder's recoveries, which may be limited only to a subordinated monetary claim rather than a continuing right in the assets post-transaction.

Key takeaways

The core provisions of the intercreditor arrangement remain unaffected by the *Dynamic Technologies* decision:

- One can reasonably expect that a court will uphold agreed priority waterfalls, subject to any new priorities for DIP financing advanced.

- Standstill provisions preventing subordinate creditors from taking enforcement steps ahead of senior lenders should not be affected as those provisions tend to promote a going concern scenario by limiting enforcement.
- Restrictions on credit agreement amendments, which are often included in intercreditor arrangements should also be largely unaffected by the *Dynamic Technologies* decision, though to the extent those provisions restrict increases to loan facilities, those restrictions may be limited to the extent necessary to facilitate DIP financing.

However, where an Intercreditor Agreement expands to include provisions aimed at pre-engineering an expedited strategy for senior lenders to realize their collateral unimpeded by subordinate creditors, significant enforceability concerns can arise. When one considers that most enforcement and realization processes in the Canadian context are implemented through some form of court supervised restructuring proceeding, this concern is heightened. *Dynamic Technologies* illustrates that courts will be reluctant to cede control of their restructuring process to the pre-filing negotiations of selected creditors who are parties to intercreditor arrangements.

Evan Cobb is a partner in our Toronto office in the firm's global restructuring group.

Mediation as a bankruptcy and insolvency game changer

Scott Atkins, Kai Luck

Introduction

While once spoken of as a "future trend", mediation is now actively being used as a key bankruptcy and insolvency tool. In this article, we outline the benefits that mediation can offer in an insolvency scenario. We also consider advances in global policy and regulatory frameworks that will help to shape the central role of mediation as part of a best practice insolvency system, and we identify recent examples where insolvency mediation has been used to achieve optimal outcomes for the benefit of creditors and other stakeholders in significant and cross-border and other cases.

The benefit of mediation in an insolvency scenario

Mediation has a major role to play in enhancing the efficiency of insolvency proceedings, the resolution of multiple creditor disputes and achieving consensus among disparate stakeholders. It can reduce delays and costs – both increasing the prospect of successful restructuring outcomes for viable entities, and producing a better return for creditors.

This is especially the case during the "pre-insolvency" stage – in which a financially distressed but viable business looks to explore options for an informal (or out of court) workout. Particularly in countries that do not have an effective pre-insolvency framework in place and where there is a focus on individual enforcement rather than collectivism, mediation can be a very effective insolvency and restructuring tool.

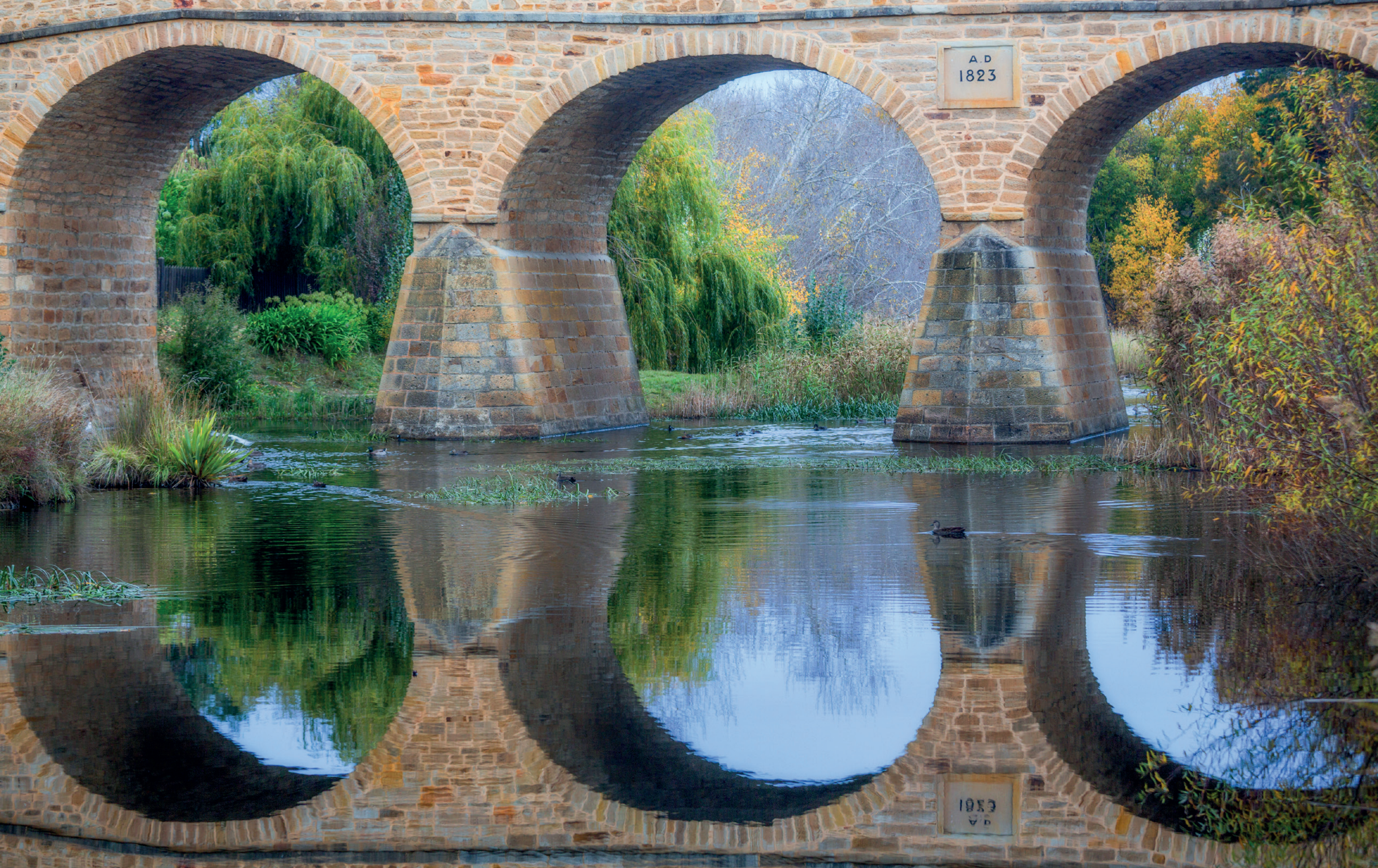
Further, in a formal insolvency context, a mediator can assist an insolvency trustee or other representative to negotiate with creditors to develop and implement a formal reorganisation plan acceptable to the required majority of creditors. As Justice Ramesh said in his judgment in the Singapore High Court in *Re IM Skaugen SE* [2018] SGHC 259, there is "tremendous utility in deploying the services of a neutral third party skilled in mediation techniques", with a mediator able to "play the invaluable role of building consensus between the debtor and the creditors in the development of the restructuring plan, and to build trust in the process".

Indeed, as noted by Justice Arjan Kumar Sikri – a former Judge of the Supreme Court of India and a current International Judge of the Singapore International Commercial Court – in his recently released book, *Constitutionalism and the Rule of Law in a Theatre of Democracy* mediation can be seen as a form of "democratic decision-making". In that sense, it can function as a key tool in achieving the consensus and creditor majorities inherent in bankruptcy and insolvency regulatory regimes.

Drawing on his experience in India, Justice Sikri has also, in other extra-judicial commentary, noted the way mediation may help to advance creditor negotiations and facilitate the approval of a restructuring plan during a corporate insolvency resolution process (**CIRP**) initiated under India's Insolvency and Bankruptcy Code 2016 (**IBC**) (see "Mediation in Corporate Insolvency: A Game Changer" in *Business World*, 14 June 2019). In doing so, Justice Sikri identifies the way mediation may reduce the delays encountered in practice under the IBC since its introduction, with litigation initiated by parties before tribunals and courts during a CIRP having been cited as one of the primary reasons for delays under the IBC. Justice Sikri also makes the important point that resolution plans agreed to during a mediation process may have the potential to be more innovative and "out of the box" than those arrived at under a typical CIRP.

In both a reorganisation and liquidation scenario, a mediator can also provide procedural cohesion and coordination for complex creditor claims in place of ad hoc enforcement proceedings that could result in years of expensive litigation and diminish property for creditors and any prospect of a successful rescue attempt.

The role of mediation in helping to achieve creditor coordination and consensus can be especially important in cross-border settings. In this context, coordination difficulties among creditors with competing claims in multiple jurisdictions and operating under often very different insolvency regimes are even greater.



Policy and regulatory settings for insolvency-based mediation

Existing frameworks that promote mediation

The use of mediation specifically to enhance informal rescue outcomes is reflected in the principles and policy recommendations released by INSOL International and the World Bank.

A mediator could play a key role within the informal workout framework set out in INSOL's "Statement of Principles for a Global Approach to Multi-Creditor Workouts" (**INSOL Principles**), the second edition of which was released in March 2017. The central idea of the INSOL Principles is that, where a debtor is found to be in financial difficulties, creditors should seek to cooperate with one another to investigate the potential for an out of court negotiated restructuring attempt to reduce costs and maximise the final return. A mediator could help to achieve the creditor coordination envisaged by the fourth principle of the INSOL Principles during an informal restructuring attempt.

Mediation is also a key feature of the World Bank's Principles for Effective Insolvency and Creditor/Debtor Regimes released in April 2021 (**ICR Principles**). The ICR Principles are intended to distil international best practice to guide countries in their design and implementation of sound and effective insolvency regimes.

Recommendation B4 of the ICR Principles states that "an informal workout may work better if it enables creditors and debtors to use informal techniques, such as voluntary negotiation or mediation or informal dispute resolution". Further, Recommendation D5.4 states that, as part of a best-practice insolvency regime, the legal system should "support and encourage the use of mediation, conciliation and other alternative dispute resolution techniques in simplified procedures" for micro and small enterprises (**MSEs**).

MSE insolvency reform is one of the key issues on the global restructuring and insolvency policy agenda at present, with a view to providing alternative insolvency processes outside the existing "one size fits all" formal insolvency options that typically involve substantial costs and time delays. A mediator could offer a distinct alternative insolvency mechanism for MSEs in financial distress.

Mediation could also play a key role within the cross-border insolvency Model Law framework, particularly in negotiating an insolvency cooperation protocol between courts and insolvency representatives in multiple jurisdictions. The appointment of a mediator in that respect can be seen to fall directly within the form of cooperation contemplated by article 27(a) of the UNCITRAL Model Law on Cross-Border

Insolvency (**MLCBI**) – that is, the appointment of a person or body to act at the direction of the court, with a view to discharging the obligations under articles 25 and 26 for courts and foreign representatives to cooperate to the "maximum extent possible" in cross-border matters where recognition and assistance is sought pursuant to the MLCBI.

Future advances

While these existing global policy and regulatory frameworks envisage mediation as a critical restructuring and insolvency resolution tool, there are a number of options to further incentivise the use of mediation in insolvency scenarios.

First, the greater use of mediation in a cross-border insolvency matter could be encouraged through the more widespread adoption and implementation of the Singapore Convention on Mediation, which entered into force on 12 September 2020. The Convention currently has only 56 signatories and 11 ratifying countries.

The Singapore Convention provides an internationally consistent framework for the expedited recognition and enforcement of settlement agreements reached during a cross-border mediation process. This creates an incentive for creditors to pursue negotiated outcomes to settle their claims, knowing that the settlement terms agreed can be enforced simply and quickly.

A precondition to the operation of the Singapore Convention is the existence of a mediation settlement that arises from a "commercial dispute" in an international matter. Arguably, in a cross-border insolvency matter, there would be an element of a commercial dispute insofar as different creditors negotiating with a debtor in a workout context each have their own distinct claims and, notionally, seek repayment of their entire debts – creating a dispute with the debtor, which necessarily may not be able to pay all those claims in full.

Further, the Singapore Convention does not apply to settlement agreements approved by a court or concluded during proceedings before a court. If insolvency proceedings have already been opened, would any mediator-led negotiated restructuring plan (or resolution of creditor disputes) be considered a settlement agreement arising "in the course of proceedings before a court"? Arguably, this condition ought to be construed more narrowly, so that it applies only if the specific subject matter of a creditor's claim had already been the focus of a court proceeding commenced before the relevant insolvency – and not where the relevant "proceeding" is a collective insolvency process involving the debtor. In any event, an informal workout plan (reached outside of a formal insolvency filing) would not be subject to any interpretational doubt.

Aside from the Singapore Convention, the introduction of new court procedural rules in local jurisdictions could support the use of mediation in insolvency matters, by providing courts with the power to refer the parties to mandatory mediation at any point of an insolvency process. Rules of that kind are currently very limited globally, with the United States being a notable exception. There, 40 of the 90 United States Bankruptcy Courts now permit, by rule or standing order, a bankruptcy judge to order the parties to a dispute to attempt mediation. In the Delaware Bankruptcy Court, a mandatory mediation program for adversary proceedings has been in place since 2004. The American Bankruptcy Institute also released in February 2015 its "Local Bankruptcy Rules for Mediation" as a resource for bankruptcy courts in adopting or revising local bankruptcy rules regarding mediation.

To ensure trust and confidence in the mediation process from creditors (thereby incentivising creditors' use of mediation in an insolvency and restructuring context), it is also important to have skilled professionals with insolvency and restructuring expertise as the eligible individuals entitled to act as mediators. This should ideally take place through a registration system. For example, there could be an additional registration qualification added to the existing registration systems for registered liquidators and other insolvency practitioners that operate in various jurisdictions across the world. It would also be optimal for there to be a common international framework for registration to bring cohesion and a degree of "quality control" given the disparate systems that operate in local jurisdictions and the importance of having a trusted process in cross-border insolvency matters. As Justice Sikri aptly notes in the context of encouraging the use of non-adversarial methods in resolving disputes across borders, "efforts must be made by the legal and regulatory framework to provide comfort to investors, especially foreign investors" (Justice Arjan Kumar Sikri, *Constitutionalism and the Rule of Law in a Theatre of Democracy*, EBC, 2023, 432).

Mediation examples in large cross-border and other insolvency cases

There are some high-profile examples which demonstrate the benefit mediation has had in achieving more efficient outcomes in cross-border insolvency proceedings.

In MF Global Holdings, for multiple entities undergoing competing insolvency processes in the United States and the United Kingdom, a court-appointed mediator helped to facilitate agreements between the United States bankruptcy trustees and the special administrators of MF Global in the United Kingdom, which avoided expensive litigation and produced a global settlement maximising returns for creditors.

In Lehman Brothers Holdings, the United States Bankruptcy Court appointed mediators to assist in the resolution of complex disputes with approximately 250 counterparties. Of the 77 proceedings reaching the mediation stage, 73 were settled in mediation and only 4 terminated without settlement. In financial terms, the settlements achieved through mediation in Lehman Brothers are estimated to have led to the recovery of over US $2 billion in additional proceeds for distribution to creditors.

In 2020, the United States Bankruptcy Court appointed Judge Drain as mediator in China Fishery Group's Chapter 11 case. The restructuring plan was confirmed in June 2021, and this was only possible through the success of mediation in narrowing and resolving the web of complex trade finance claims.

The use of mediation to resolve cross-border insolvency and restructuring matters can be expected to continue in coming years with the growing complexity of the substantive legal matters that will come before bankruptcy and insolvency courts. Notably, there will be an important role for mediation in centralising and bringing cohesion to proceedings involving mass tort claims.

The valuable role of mediation in that context was seen in the Boy Scouts of America bankruptcy in the United States. Boy Scouts, which filed for Chapter 11 in February 2020, faced, among other claims, 82,209 unique claims alleging "scouting-related" sexual abuse. In this case, three court-appointed mediators, including a former bankruptcy judge, played a pivotal role in negotiating and resolving an array of disputes that paved the way for Boy Scouts to obtain confirmation of its Chapter 11 reorganisation plan in September 2022, with the plan becoming effective in April 2023.

The cornerstone of Boy Scouts' reorganisation plan is a series of mediated settlements resolving a complex array of overlapping liabilities and insurance rights and the establishment of trust distribution procedures to administer the largest sexual abuse compensation fund in United States history: a settlement trust that will provide non-contingent funding of US $2.48 billion in cash and property, in addition to other assets, including insurance rights, to benefit abuse survivors. In exchange for making financial or other insurance contributions to the settlement trust, Boy Scouts, local councils, contributing chartered organisations and settling insurance companies receive the protection of a non-consensual release of tens of thousands of abuse claims, which are channelled to the settlement trust. The trust distribution procedures implement a process through which abuse claims will be reviewed and valued by the settlement trust based on the nature of the abuse. The settlement trust will also be entitled to pursue additional recoveries for the benefit of abuse survivors against non-settling parties, including several chartered organisations and insurance companies.

In its Opinion issued on 28 March 2023, the Delaware District Court noted there were thousands of hours of mediated negotiations during the Chapter 11 proceedings, and the mediators managed to secure support for the final reorganisation plan from every estate fiduciary and nearly every organised creditor group. The Court called this "a commendable result for such a lengthy, contentious and emotionally charged proceeding".

While mediation did not resolve the *substance* of the abuse claims, it did maximise *procedural* efficiency by channelling claims into a centralised trust assessment and distribution process to take place, in the first instance, out of court, and mitigating the considerable costs that would be incurred in resolving each individual claim in a court-based, adversarial setting.

Conclusion

Mediation has a significant role to play in coordinating the claims of disputing creditors in an insolvency context and guiding creditors towards a successful restructuring outcome. Mediation is also a valuable means to achieve court-to-court cooperation and communication in cross-border insolvency matters.

The use of mediation in an insolvency setting has, to date, had the strongest uptake in the United States, where mandatory court referral powers to mediation in bankruptcy matters are common in many courts and have been frequently utilized in Chapter 11 cases. Extending these powers in other jurisdictions is one way to incentivise the growth of mediation as a viable insolvency resolution tool – as well as encouraging the further adoption and implementation of the Singapore Convention to provide an internationally-consistent framework for the enforceability of mediation settlement agreements in a cross-border insolvency matter.

A version of this article will be published as an essay in the Insolvency Law Academy's forthcoming book (anticipated to be released in February 2024), "An Anthology on Mediation in Insolvency".

Scott Atkins is Global Chair and Global Co-Head of Restructuring and Dr. Kai Luck is Special Counsel, both in our Sydney office in the firm's global restructuring group.

Blaze to bankruptcy: US bankruptcy courts display increased willingness to entertain cannabis related bankruptcy filings

Michael Berthiaume

Introduction

The US Bankruptcy Code provides significant advantages to businesses looking to restructure their financial affairs, liquidate assets, and administer claims. The cannabis industry, however, has had particular difficulty gaining access to the Bankruptcy Code. While medical and recreational use of cannabis and cannabis related products is now legal in certain US states, it is still illegal at the federal level. As a result, US bankruptcy courts have struggled to reconcile the federal prohibition against cannabis with businesses and business activities now made legal by a number of US states.

Generally speaking, in bankruptcy, the presumption has been that cannabis related entities categorically are not eligible for bankruptcy protection in the US. US bankruptcy courts had consistently—even reflexively—dismissed cases filed by cannabis related entities based upon violations of a US federal statute, the Controlled Substances Act ("CSA"). Essentially, those courts found that the bankruptcy process, the bankruptcy court, and the court's agents could not approve a plan of reorganization or administer assets in a manner that would be illegal under the CSA. This perceived categorical bar thus prevented US cannabis related entities, and international cannabis related entities with US assets or subsidiaries, from using the US bankruptcy process to reorganize their business, restructure debts, or sell assets. Likewise, international cannabis related insolvency proceedings have been unwilling to seek recognition under Chapter 15 of the US Bankruptcy Code.

Some US bankruptcy courts have begun pushing back against the perceived *per se* ban. These courts look critically into the bankrupt debtor's assets and business to discern to what degree the debtor's enterprise touch or concern cannabis. Where a debtor's business is adequately removed from ongoing violations of the CSA (and does not arise from the manufacture and distribution of cannabis products) dismissal is <u>not</u> required.

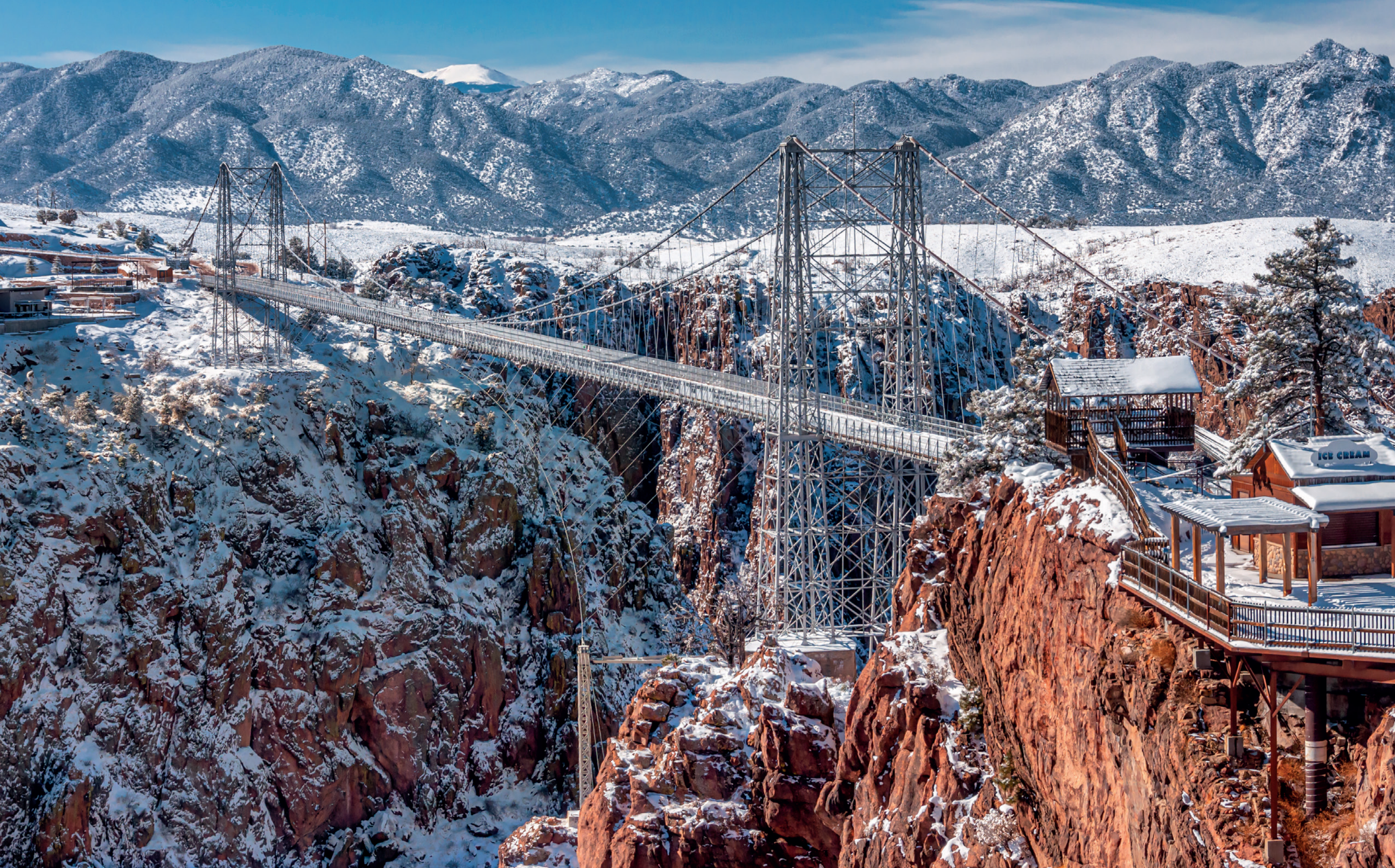
This alternative approach creates a paradigm. On one end of the spectrum are cannabis related entities that directly manufacture and distribute cannabis and cannabis products. Even under recent court decisions, those entities most likely will remain ineligible for bankruptcy protection no matter what court reviews the case. At the other end of the spectrum are those entities which do not *directly* participate in the manufacture or distribution of cannabis products. A new line of cases appears have emerged, permitting those businesses to avail themselves of US Bankruptcy Code protections.

The foundations and a categorical bar against bankruptcy relief

Until 2019, US bankruptcy courts reflexively dismissed bankruptcy cases filed by cannabis related entities. Generally, the United States Trustee ("UST"), an officer of the United States Department of Justice responsible for overseeing the administration of bankruptcy cases, argued that a cannabis related entity's violations of applicable nonbankruptcy law constituted cause for dismissal.

Typically, the UST would point to violations of the CSA (which, by virtue of the Supremacy Clause of the US Constitution, would prevail over state law when there is a conflict between federal and state law) to justify dismissal. Under the CSA, it is illegal to possess, grow, or dispense cannabis and cannabis related products, and it is unlawful to open, lease, rent, use, or maintain any place to manufacture or distribute cannabis and cannabis related products. All property and proceeds of property obtained in violation of the CSA are subject to forfeiture. These violations, the UST would argue, establish a lack of "good faith," constitute "gross mismanagement" of the bankruptcy estate, and render the bankruptcy court and agents of the court unable to administer the debtor's assets.

Many courts have agreed, particularly where the debtor's business intended to manufacture or distribute cannabis products postpetition, or where the bankruptcy estate would be required to administer proceeds from the actual sale of a cannabis related business for the benefit of creditors.



For example, in a Colorado case, the debtor sold indoor hydroponic supplies for use in growing marijuana (a cannabis product). Dismissing the case, the bankruptcy court found the debtor's sale of equipment to the cannabis industry was a violation of the CSA, and the debtor's continued reliance on this income required dismissal. Similarly, courts have ruled that ownership of property used in the cannabis industry constitutes cause for dismissal. For example, a bankruptcy court in Michigan dismissed the case of a debtor which had leased its property to a company that ran a medical marijuana dispensary. Likewise, in Colorado, the bankruptcy court dismissed a case involving a debtor which had leased property to a marijuana growing operation. In all of these cases, the debtor's business operated in contravention of the CSA, and those connections to the cannabis industry were sufficient to restrict a bankruptcy court's ability to provide relief under the US Bankruptcy Code.

Once bankruptcy was not available, distressed cannabis businesses and their creditors were forced to turn to US state-law insolvency proceedings (*e.g.,* assignments for the benefit of creditors; receiverships) or international forums to restructure their debts and liquidate their assets. While viable, assignment proceedings and receiverships are not as advantageous as a sale or plan of reorganization under the Bankruptcy Code. They cannot deliver to any good faith purchaser either the transfer of contracts or leases over the objection of the non-debtor parties to those same agreements, or convey assets free and clear of all liens, claims, and interests. Moreover, these state law proceedings do not provide for recognition of foreign insolvency proceedings as is the case under Chapter 15 of the US Bankruptcy Code.

The developing spectrum of potential bankruptcy relief

Recently, certain US bankruptcy courts in California and Colorado have disagreed that a violation of the CSA *requires* dismissal of a bankruptcy case. These cases trumpet that "the mere presence of marijuana near a bankruptcy case does not automatically prohibit a debtor from obtaining bankruptcy relief." Rather, due to the varying nature and extent of a debtor's potential involvement in the cannabis business and the wide latitude of discretion granted to US bankruptcy courts, a bankruptcy court must make explicit findings to justify dismissal. Instead of a "bright line" rule, recent courts assert that the totality of the circumstances should be examined to determine (1) whether the debtor's connections actually violate the CSA or other federal statute, and (2) even if there is a violation of the CSA, whether that violation

justifies cause to dismiss the bankruptcy case. In other words, these courts discern the *degree* of connection to cannabis to determine whether dismissal would be appropriate—"ongoing postpetition violations [of the CSA] are far more problematic."

For example, in one 2020 case in California, the debtor's business required and would continue to require the sale of cannabis growing equipment. The bankruptcy court dismissed the case, finding both that the debtor's sale of that equipment was an ongoing violation of the CSA, and the debtor's business would continue to be tightly connected and dependent upon the cannabis industry.

However, just a few months ago, another bankruptcy court in California came to an entirely different result in *In re Hacienda Company, LLC,* 647 B.R. 748 (Bankr. C.D. Cal. 2023). In *Hacienda,* the bankruptcy court refused to grant the UST's motion to dismiss a bankruptcy case because it could find no *ongoing* violation of the CSA. The debtor was a former wholesale manufacturer of cannabis products that had ceased operations altogether and had sold the company in exchange for cash and shares of its purchaser, which was also a cannabis related entity. Entering bankruptcy, the debtor's only asset was the shares of its purchaser, which the debtor intended to liquidate and distribute the proceeds to its creditors. The UST moved to dismiss. The bankruptcy court disagreed with the UST, finding that the debtor's ownership of the stock and proposed sale thereof did not violate the CSA. While the debtor may have previously operated in violation of the CSA, the debtor was not proposing to use its assets to invest in or profit from a cannabis related entity. Further, the sale of the debtor's stock alone did not require the debtor, the court, or the court's agents to violate any federal law. Moreover, on September 22, 2023, the bankruptcy court went one step further and entered an order confirming the debtor's Chapter 11 plan of reorganization, permitting the debtor to sell the shares of its purchaser on the Canadian Securities Exchange and distribute the proceeds to its creditors. Importantly, the bankruptcy court held that a distribution of sale proceeds through the plan is not a sale of cannabis products, "nor will it add a single dollar to any cannabis enterprise."

These same courts have also pushed back against the notion that a violation of the CSA (if it exists) is *per se* cause to dismiss a bankruptcy case. *See, e.g., In re Roberts,* 644 B.R. 220, 231 (Bankr. D. Colo. 2022) ("Because the Court cannot explicitly articulate its factual bases for a marijuana-based dismissal beyond an unacceptable level of speculation, the Court will not dismiss [the debtor's] case due to cannabis . . . ."); *In re Olson*, 2018 WL 989263, at *7 (B.A.P. 9th Cir. 2018) (J. Tighe concurring) ("the presence of marijuana near the case should not cause mandatory dismissal."). As observed by these courts, bankruptcy courts often consider debtors whose past and present activities include violations of nonbankruptcy law, such as failed Ponzi schemes, alleged sexual abuse, instances of fraud, and countless other material and immaterial violations of federal law. If a violation of nonbankruptcy law required dismissal, bankruptcy courts would be forced to dismiss a great deal of cases in contravention to the express purpose of the US Bankruptcy Code.

Instead, even in the face of a violation of the CSA or other federal law, these courts reason that discretion must be exercised to determine whether, given the facts and circumstances presented, dismissal is in the best interest of creditors and the bankruptcy estate. For example, in confirming the Chapter 11 plan, the bankruptcy court in *In re Hacienda* found that even if the debtor's ownership and sale of stock in its purchaser (a cannabis related entity) had constituted a violation of the CSA, creditors of the estate and parties in interest actually stood to *benefit* from the bankruptcy case and an orderly liquidation of assets. Under those circumstances, the court determined that dismissal would not be warranted.

Taking advantage of the spectrum

The willingness of some bankruptcy courts to reject the old *per se* test in favor of essentially an evaluation of a spectrum of facts and circumstances surrounding how the debtor operates its business may open new avenues of opportunity for both US and international cannabis related entities to gain the protection of the US Bankruptcy Code.

While the contours of this spectrum remain to be tested, US based cannabis related entities and those who invest in them should monitor any new cases filed, as additional enterprises inevitably will seek to take advantage of these new tools and develop the case law available on these issues.

International cannabis related entities and investors may also benefit from this changing landscape, as the recent rejection of a *per se* ban of cannabis related entities may open the door to Chapter 15 recognition of foreign cannabis related proceedings. Recognition under Chapter 15 of the US Bankruptcy Code grants a foreign debtor many of the protections afforded a debtor under the US Bankruptcy Code, including the automatic stay, recognition of sale orders, and staying enforcement of judgments.

Until recently, US bankruptcy courts may have denied recognition under Chapter 15 pursuant to the "public policy exception," which permits a court to refuse to grant recognition if it would be "contrary to the public policy of the United States." After all, nearly all cannabis related bankruptcies have been dismissed by US bankruptcy courts for "cause" out of fear that the court would be forced to administer illegal assets.

The recent court decisions outlined above, however, may afford bankruptcy courts more latitude to ignore that *per se* rule depending on where the debtor lands on this new spectrum. If at least some US bankruptcy courts are actually permitting certain cannabis related bankruptcies to proceed, then it becomes much harder for the UST to make its "public policy" objection and demand dismissal. Thus, if a foreign debtor is able to demonstrate that its case *would* be accepted by a US court, it may well defeat a public policy objection / motion to dismiss brought by the UST.

Further, the usual justifications for dismissal of cannabis related entities are not present in Chapter 15. As discussed, many courts have dismissed cannabis related bankruptcies involving ongoing violations of the CSA for "cause" out of fear the court or its agents would be forced to administer assets in contravention of the CSA. In Chapter 15, however, the applicable sections of the Bankruptcy Code that provide for dismissal for cause (11 U.S.C. § 1112) do not apply. Instead, the only means to deny recognition of a Chapter 15 case is the public policy exception.

Also, a court's concerns of administering illegal assets should be assuaged in a Chapter 15 case, because recognition of a foreign proceeding under Chapter 15 does not create an estate of the debtor's property that must be administered by the US courts. *In re JSC BTA Bank*, 434 B.R. 334, 341 (Bankr. S.D.N.Y. 2010). Instead, the bankruptcy court must merely recognize and facilitate the reorganization in another (presumably lawful) jurisdiction. Therefore, in applying the public policy exception narrowly, a chapter 15 recognition petition may find success in US bankruptcy courts.

In conclusion, the recent decisions from California and Colorado demonstrate that there is an emerging spectrum of potential relief for cannabis related businesses under the US Bankruptcy Code. Both Chapters 11 and 15 may provide an avenue for restructuring of debts or recognition of foreign proceedings that affords significant advantages for stakeholders, and both US and international cannabis related entities and their investors should monitor this area of the law as it continues to develop.

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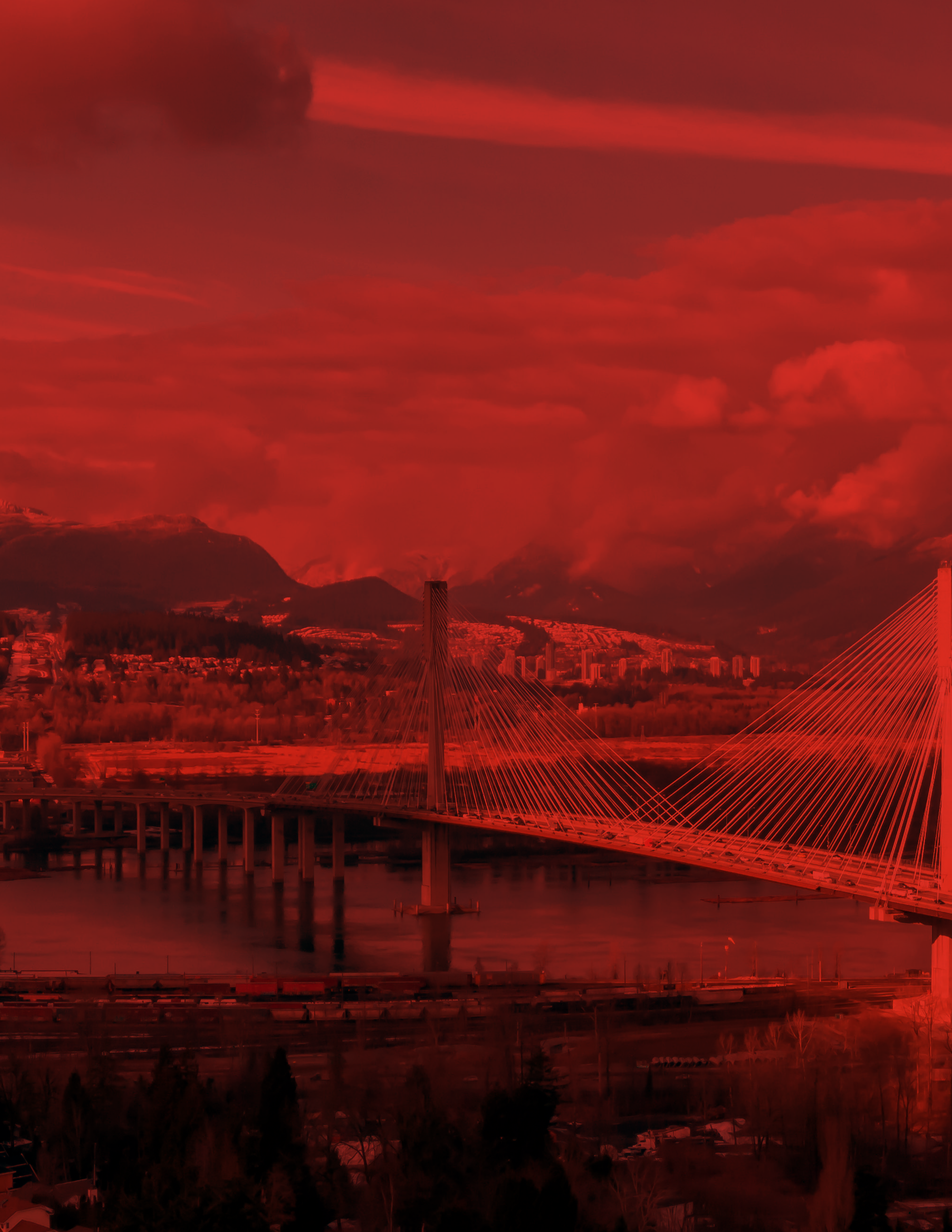

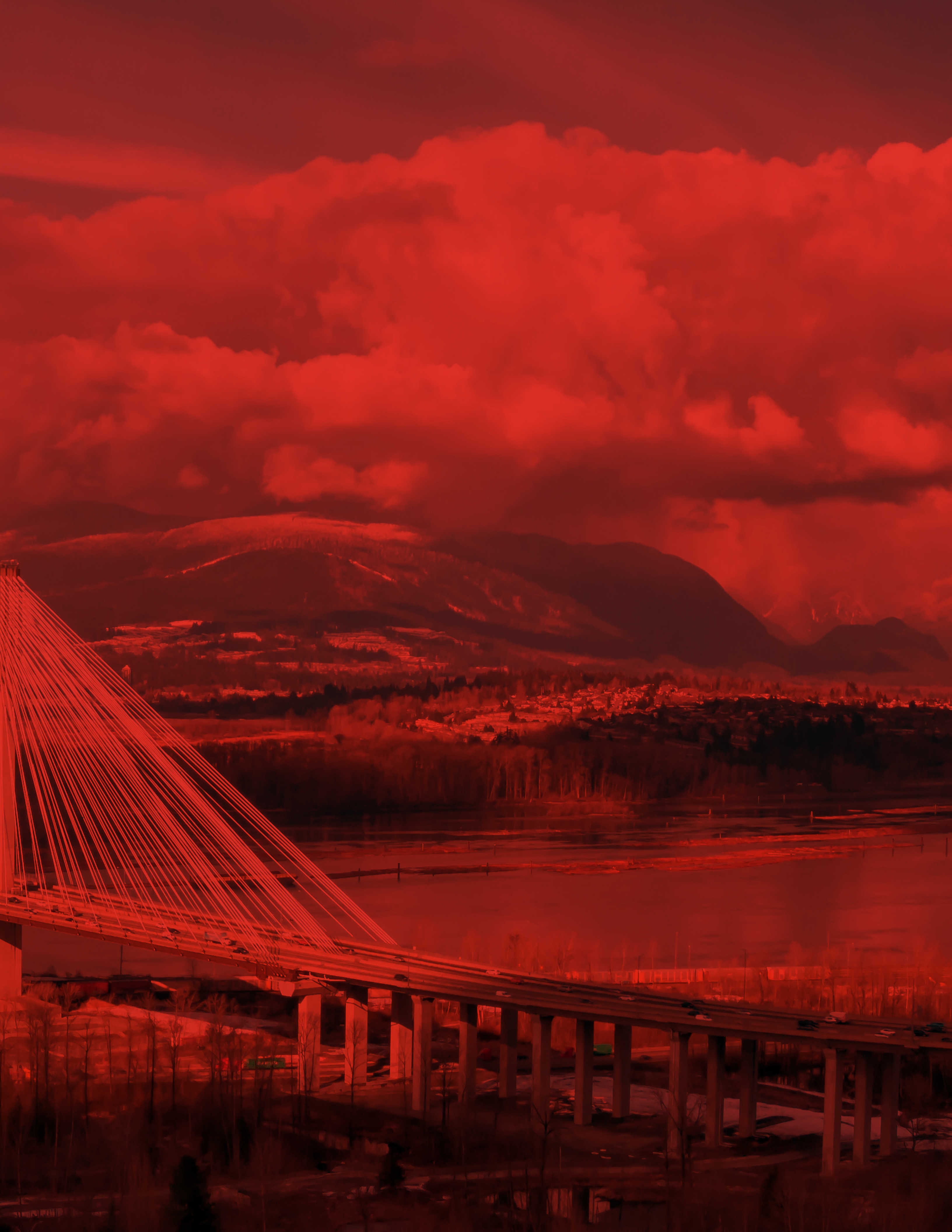

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