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International Restructuring Newswire

A quarterly newsletter from the bankruptcy, financial restructuring and insolvency team at Norton Rose Fulbright

Spring 2019

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International Restructuring Newswire

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To our clients and friends:

At Norton Rose Fulbright we are constantly reminded that the restructurings of global businesses require legal experience in multiple jurisdictions. Cognizant of the need to stay abreast of developments in major economic centers, we feature articles in this issue on new cross-border developments in Australia, the UK, Canada and the US.

Given our market-leading experience throughout the world in representing global financial institutions in complex, cross-border restructurings, we are pleased to announce an upcoming video series, the **Norton Rose Fulbright Global Restructuring Institute.** Led by Howard Beltzer, the series will include three separate programs, with faculty consisting of senior restructuring lawyers from throughout our network. The first program will tackle general issues in multinational restructurings, including jurisdictional requirements, restructuring options, ancillary foreign proceedings, and the ability to obtain recognition of foreign proceedings. The second program will focus on litigation issues attendant to cross-border restructurings, including lender liability, preferences and fraudulent conveyances, equitable subordination, releases and cramdown/voting issues. The third program will address corporate and enforcement issues, such as foreclosure and exercise of remedies, credit bidding, corporate governance, and derivative and related transactions. We hope to address the most important and timely issues in the global restructuring arena. Please look for further details in coming weeks.

I would be remiss in not noting the passing of a good friend and one of the titans of the restructuring and insolvency world. Gabriel Moss passed away on March 15. Gabriel was an internationally recognized UK barrister and scholar. We worked with Gabriel on numerous occasions, including as our expert on schemes of arrangement in Hopewell, the landmark recognition case before the late Chief Judge Tina Brozman in the Southern District of New York. Not only did he provide insightful testimony before the court, but his easy-going manner clearly charmed the judge (and we prevailed to boot).

He will be greatly missed.

Howard Seife
Global Head
Financial Restructuring and Insolvency

In the news

RBC Capital Markets Conference
Chicago, Illinois: January 24, 2019
Larry Larose participated in a day-long conference hosted by RBC Capital Markets in Chicago. The conference was attended by municipal bond investors and hedge funds, analysts, rating agencies and bond insurers , focusing on the credit fundamentals and uncertainties of Chicago. Larry's panel discussed the potential treatment of Pension Obligation Bonds in a restructuring scenario.

INSOL International Webinar
New York, NY: March 14, 2019
Frank Vazquez was a featured speaker in INSOL International's first-ever webinar. The subject was Recent Developments in the Application of the Model Law on Cross-Border Insolvency - Recognition in the U.S. of Latin American Proceedings. Howard Seife moderated the program.

ABA's Aircraft Financing Subcommittee 2019 Spring Meeting
Vancouver, British Columbia, Canada: March 28-29, 2019
David Rosenzweig participated on a panel at the ABA's Aircraft Financing Subcommittee 2019 Spring Meeting. The panel discussed issues related to the Cape Town Convention in the Oceanair/Avianca Brasil restructuring case in Brazil and chapter 15 case in New York.

INSOL International Annual Regional Conference
Singapore: April 2–4 , 2019
Howard Seife spoke at the INSOL International Annual Regional Conference in Singapore. His panel topic was CEO Corner – Seeing and Seizing Opportunities For Your Business.

In the news

Kuwait Bankruptcy Law Reform

Vienna, Austria: May 2–3, 2019

Mark Craggs will be participating in a workshop organized by the US Department of Commerce's Commercial Law Development Program on Kuwait's new bankruptcy laws, together with Samira Musayeva of the UNCITRAL Secretariat and Judge Martin Glenn, US Federal Bankruptcy Judge.

ABI's 21st Annual New York City Bankruptcy Conference

New York: May 22, 2019

Sam Kohn will be speaking on a panel at ABI's 21st Annual New York City Bankruptcy Conference. The panel will present on the topic of unique issues that arise when an LLC entity files for bankruptcy. The panel includes the Hon. Kevin J. Carey, United States Bankruptcy Judge, District of Delaware.

R3 Breakfast Briefings on Aviation Insolvency

London, UK, and Manchester, UK: June 5 and July 4, 2019

Mark Craggs will be a panellist for a discussion of the practical issues encountered in airline insolvencies, together with prominent UK insolvency practitioners, as part of breakfast briefings in London and Manchester to be hosted by R3, the Association of Business Recovery Professionals.

International Insolvency Institute, NextGen Program

Barcelona, Spain: June 16, 2019

Mark Craggs will be participating in a debate on the relative merits of insolvency filings in the UK and Singapore, as part of the III NextGen Program prior to the International Insolvency Institute annual conference in Barcelona.

Nexia Conference

Singapore: June 24, 2019

Mark Craggs will be joining a panel discussion on global opportunities and challenges in cross-border restructuring at the Nexia Turnaround, Restructuring & Insolvency Business Group (association of insolvency practitioner firms) annual conference in Singapore.

ACC Annual Meeting

Phoenix, Arizona: October 27-30, 2019

Jason Boland and Rebecca Winthrop will be speaking at the annual meeting of the Association of Corporate Counsel. They will discuss What Every In-house Counsel Needs to Know About Bankruptcy Risk for the Next Economic Downturn.

Municipal Pensions and OPEB Liabilities in Chapter 9

Lawrence Larose participated in video interview with Beth Wiggins of the Federal Judicial Center on Municipal Pensions and OPEB Liabilities in Chapter 9 in December. The interview is the second in a series to be published as part of the FJC's publication of "Navigating Chapter 9 of the Bankruptcy Code", to which Larry contributed.

INSOL International

Scott Atkins was appointed for a two-year term as Vice-President of INSOL International on April 2, 2019. INSOL is the world's leading federation of insolvency professionals. There are currently over 44 member associations with over 10,500 professionals participating as members of INSOL. INSOL's conferences and seminars provide a valuable source of professional knowledge on global restructuring issues.

Australian Restructuring Insolvency and Turnaround Association

Scott Atkins will become President of ARITA effective May 28, 2019 for a two-year term. ARITA is Australia's leading organization for restructuring, insolvency and turnaround professionals. Its membership comprises lawyers, accountants, lenders and other insolvency professionals working with underperforming businesses and financially challenged individuals.

Melbourne Office Assists Ferrier Hodgson on Plan to Merge with KMPG

Partners Jeremy Wickens and Steve Palmer and their teams assisted advisory firm Ferrier Hodgson on its plan to merge with giant international professional services firm KPMG.

The deal, announced by the two firms on March 14, aims to create one of Australia's largest restructuring services and forensic advisory businesses. It is scheduled for completion by 30 June 2019.

The deal is representative of a world-wide trend of consolidation and globalisation of professional services firms, which is reshaping industries such as accounting and law.

Ferrier Hodgson was created in 1976 and is one of Australia's first independent firms specialising in restructuring, forensic, performance improvement and financial advisory. Under the terms of the deal, KPMG Australia will acquire Ferrier Hodgson's business located in Sydney, Melbourne, Brisbane and Perth. The Norton Rose Fulbright team advised Ferrier Hodgson on all legal elements of the agreement, as well as assisting Ferrier Hodgson to manage its many stakeholders.

Latest Airline Restructuring News – Avianca Brazil: What happens in Cape Town stays in Cape Town

Julie Goodrich Harrison

Chapter 15 of the United States Bankruptcy Code promotes cooperation between the United States courts and parties involved in international insolvency proceedings. A recent chapter 15 case in the United States Bankruptcy Court for the Southern District of New York has caused some turbulence in the aviation finance world concerning the precise role that the U.S. Bankruptcy Court plays in such a case. Before we turn to the specifics of the case, we'll take a quick jaunt to Cape Town.

The Cape Town Convention and Aircraft Protocol

In late 2001, 68 countries and 14 international organizations attended the Diplomatic Conference to Adopt a Mobile Equipment Convention and an Aircraft Protocol in Cape Town, South Africa. At the closing of the Diplomatic Conference, 53 states signed a treaty and aircraft protocol (together, the "Cape Town Convention"), which extended modern commercial finance laws to international transactions involving aircraft and aircraft engines and provided a range of basic default and insolvency-related creditor remedies for airline insolvency proceedings. The Cape Town Convention was strongly supported by the aircraft manufacturing industry, financiers, and the key government agencies involved, and by the Aviation Working Group, a non-profit entity comprised of the world's major aviation manufacturers, leasing companies, and financial institutions, which was formed to contribute to the development of the Cape Town Convention. As of 2018, the aircraft protocol had 73 contracting parties, including the United States (ratified October 2004) and Brazil (ratified November 2011).

The Cape Town Convention included provisions related to the rights of aircraft lessors and financiers in insolvency cases, including an alternative akin to Section 1110 of the U.S. Bankruptcy Code. Under the Cape Town Convention, a contracting state may choose between one of two alternatives by making a declaration of which alternative would apply upon occurrence of an insolvency-related event. See Article XI of the Aircraft Protocol. As relevant here, Brazil declared that it would apply Alternative A in all insolvency proceedings and require that, within 30 days of initiating a proceeding, a debtor must either (a) give possession of an aircraft to the creditor or (b) cure all defaults regarding that creditor and agree to perform all future obligations under the applicable agreement. Under Alternative A, if the debtor fails to take either action by the expiration of the 30 days, the creditor may exercise any and all available remedies, and local insolvency law may not prevent or delay the creditor from exercising its remedies beyond the 30 day period.[1]

To ensure cooperation between contracting states, the Cape Town Convention requires that the courts of other contracting states apply the declared alternative of a contracting state with primary insolvency jurisdiction. Thus, where a debtor files an insolvency-related proceeding in Brazil, other contracting states must apply also Alternative A in related proceedings. With this background, we turn to the recent insolvency filing of one of Brazil's largest airlines.

Avianca Brazil files for judicial restructuring in Brazil

Avianca Brazil, officially known as Oceanair Linhas Aéreas S/A, is Brazil's fourth-largest airline by both domestic and international traffic in Brazil. As is customary with most large airlines, Avianca Brazil's aircraft and engines are subject to lease and sublease agreements. Facing an economic crisis, increased fuel costs, and foreclosure actions, in December 2018, Avianca Brazil filed a petition for judicial restructuring in the Brazilian Bankruptcy Court. This filing initiated the first Brazilian airline bankruptcy proceeding since the Cape Town Convention became effective in Brazil in May 2013. Avianca Brazil asked the Brazilian court for emergency relief to stay actions filed by three of its lessors seeking to repossess fourteen of its aircraft. The following day, the Brazilian court granted the request for emergency relief, suspending the foreclosure actions as well as "future actions that aim the seizure or practice of other acts for constriction of aircrafts and/or engines."

Several days later, on December 13, 2018, the Brazilian court reconsidered its suspension of the foreclosure actions upon request of one of the lessors. Referencing the Cape Town Convention, the lessor argued that the foreclosure actions could only be stayed during an initial period of 30 days. The Brazilian court agreed, finding that the Cape Town Convention was "undeniabl[y] applicable to the case" and holding that the "suspension of the repossession orders will be valid for the period of 30 days, [which is the] waiting period defined by the Brazilian government by adhering to the referred convention." The Brazilian court set January 14, 2019 as the expiration of the 30-day period, and ordered that for the next 30 days, the lessors of aircraft were prohibited from exercising their rights and remedies under the Cape Town Convention and under their lease agreements.

The foreign representative requests U.S. recognition and extension of the stay

As an international airline, Avianca Brazil holds licenses at various U.S. airports and is party to U.S. law-governed fuel contracts, operational leases, and other service contracts with U.S. counterparties. To deal with these U.S.-related issues, Avianca Brazil initiated a chapter 15 filing in the United States Bankruptcy Court for the Southern District of New York. During the initial 30-day waiting period, the foreign representative requested that the U.S. Bankruptcy Court recognize the foreign proceeding through the Chapter 15 process and grant provisional relief to Avianca Brazil under Chapter 15, including a request to apply the automatic stay of the U.S. Bankruptcy Code to Avianca Brazil's property within the territorial jurisdiction of the United States. After holding a hearing on January 3, 2019, the U.S. Bankruptcy Court entered an order (the "Provisional Order") granting provisional recognition and relief, and imposed a stay within the territorial jurisdiction of the United States through the date of the hearing on recognition of the Brazilian insolvency proceeding, which was scheduled for January 22, 2019.

The U.S. Bankruptcy Court's entry of the Provisional Order without reference to the January 14, 2019 termination date of the stay in Brazil threw the lessors into a tailspin. Several lessors wrote to the U.S. Bankruptcy Court (and later followed up with a formal objection to recognition), informing the judge that the lessors believed the Provisional Order was in direct conflict with the Cape Town Convention, as it improperly extended the stay beyond the initial 30-day waiting period. Arguing that the Cape Town Convention requires the U.S. Bankruptcy Court to apply the Cape Town Convention in accordance with Brazil's declaration of Alternative A, the lessors requested that the U.S. Bankruptcy Court incorporate additional language into the Provisional Order that would clarify the lessors' abilities to exercise their rights and remedies in the U.S. following expiration of the 30-day period, as set forth in the Cape Town Convention. The Aviation Working Group submitted its own letter to the U.S. Bankruptcy Court, expressing its agreement with the lessors' letter and informing the U.S. Bankruptcy Court that "the expiry of the waiting period is a fundamental provision of the treaty and that no extension of the waiting period is permitted."

The U.S. Bankruptcy Court's entry of the Provisional Order without reference to the January 14, 2019 termination date of the stay in Brazil threw the lessors into a tailspin.

Not surprisingly, the foreign representative opposed the lessors' requests, arguing that the lessors waived their right to object to the Provisional Order at the January 3 hearing and that the purpose of Chapter 15 is for the U.S. Bankruptcy Court, acting in its ancillary capacity, to aid the foreign insolvency proceeding, rather than to second guess the Brazilian court or impose a contrary rule that might undermine Avianca Brazil's ongoing restructuring efforts in Brazil.

Following a status conference, the U.S. Bankruptcy Court agreed with the foreign representative and declined to modify the Provisional Order, but commented that the issues remained up in the air and could be raised at the January 22 hearing on recognition of the foreign proceeding.

The Brazilian court extends the 30-day deadline

While the Chapter 15 proceeding was pending in the U.S., the Brazilian court held a hearing on January 14. Avianca Brazil and the lessors reported to the Brazilian court that they had been unable to reach an agreement on a restructuring. Rather than allow the stay to terminate, the Brazilian court instead extended the stay to February 1, 2019, conditioned upon Avianca Brazil (a) submitting proposals by February 1 for making payments of past-due amounts to the lessors or making arrangements for the return of the aircraft or engines, and (b) making payments due as from February 1 on the dates laid out in the originally signed contracts. The Brazilian court expressly ordered that if Avianca Brazil failed to fulfill either obligation, the lessors could immediately exercise their rights to repossess the aircraft or engines.[2]

The Brazilian court expressly ordered that if Avianca Brazil failed to fulfill either obligation, the lessors could immediately exercise their rights to repossess the aircraft or engines.

The U.S. Bankruptcy Court grants recognition

Prior to the Brazilian court's January 14th ruling, the question before the U.S. Bankruptcy Court was relatively simple: should the court limit the stay under the U.S. Bankruptcy Code to the 30-day period provided for both in the Brazilian court's December 13th order and in the Cape Town Convention? But once the Brazilian court extended the 30-day period, the U.S. Bankruptcy Court now had to decide whether it would act solely as an ancillary arm to the Brazilian court, rubber-stamping the extension to February 1, 2019, as urged by the foreign representative, or whether the court was independently bound to apply the Cape Town Convention, which expressly prohibited a further extension of the stay past January 14. Ultimately, the U.S. Bankruptcy Court ruled that its role was not to second-guess the decisions of the Brazilian court, but merely to facilitate cooperation and maximize assistance to the Brazilian restructuring proceedings. The U.S. Bankruptcy Court granted recognition of the Brazilian proceedings and ordered that the lessors could not take any action within the United States inconsistent with any orders issued by the Brazilian court.

[1] Alternative B, on the other hand, places the onus on the creditor to request that the debtor notify the creditor in a specified time period whether the debtor will (a) cure all defaults and perform under the agreement or (b) give the creditor the opportunity to take possession of the aircraft. If the debtor fails to provide notice of cure or fails to allow the creditor to take possession, the creditor must seek court authorization before exercising its remedies to repossess the aircraft.

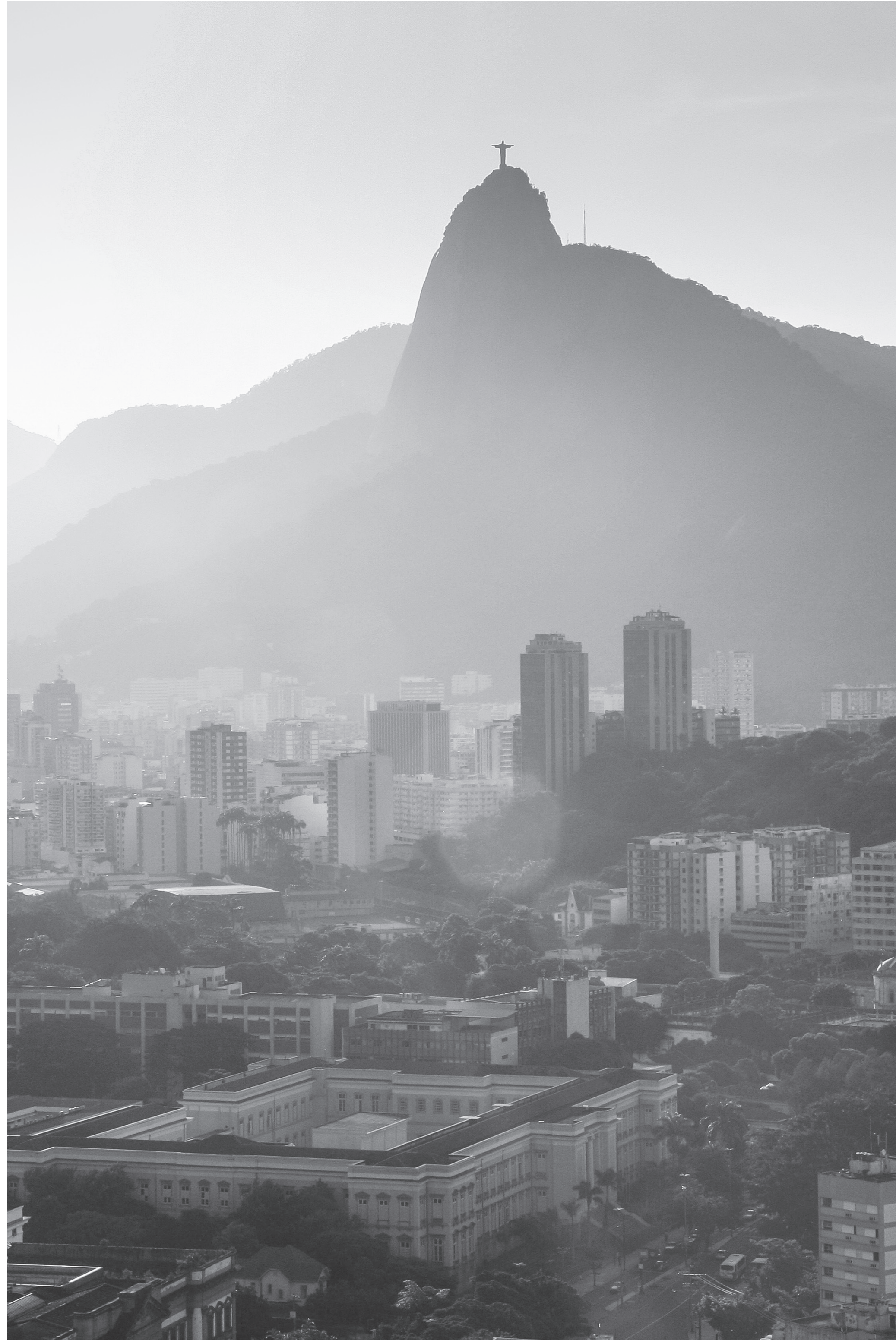
[2] The Brazilian court later extended the stay to April 15, 2019, coinciding with a general creditors' meeting set to commence on or about March 29, 2019. On March 18, 2019, the Sao Paulo Appeals Court issued a ruling determining that Avianca Brazil failed to make payments to certain lessors in accordance with these conditions. The Appeals Court therefore allowed the lessors to take actions to repossess their aircraft. The decision was made effective immediately, but it is subject to affirmation or rejection by the Brazilian Supreme Court, which review is pending as of the date of publication of this article.

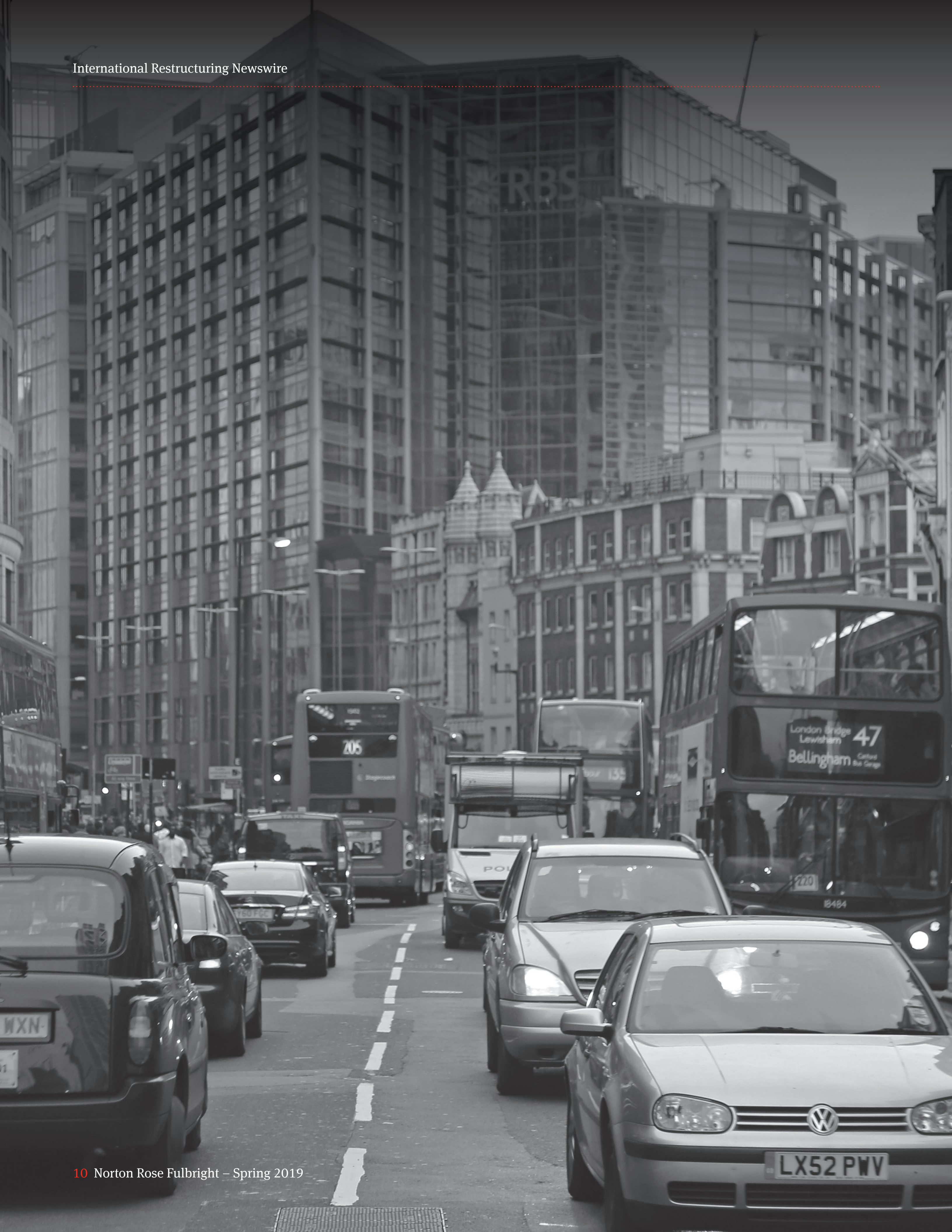
What is left of the Cape Town Convention?

These rulings in Brazil and the U.S. seem to fly in the face of the protections afforded by the Cape Town Convention. In essence, the foreign representative was allowed to use Chapter 15 to circumvent an international treaty, due to the Brazilian court's apparent contravention of Brazilian law providing for a 30-day waiting period without extension. Had the U.S. Bankruptcy Court applied Alternative A in conformity with the Brazilian declaration strictly as a matter of compliance with a U.S. treaty, Avianca Brazil and the lessors certainly would have been subject to inconsistent rulings, but the spirit of the Cape Town Convention would have been preserved. In the event of future airline insolvency proceedings, it will be interesting to see whether other signatory countries follow the Brazilian court's rulings in this case or strictly apply the waiting period without extension.

Postscript: In recent weeks, Azul, S.A. (another Brazilian airline) has come forward offering to acquire certain of Avianca Brazil's assets in a plan for approximately $105 million in cash. Avianca Brazil also secured debtor-in- possession financing from funds controlled by Elliot Management, which would end up with a substantial minority stake in the "new" Avianca Brazil acquired by Azul, S.A.

Julie Goodrich Harrison is an associate in our Houston office in the firm's global financial restructuring and insolvency group.

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Review of jurisdictional issues in recent cross-border schemes of arrangement

Mark Craggs and Matthew Thorn

Introduction

A scheme of arrangement is a procedure under the Companies Act 2006 (UK) enabling a company to make a compromise or arrangement with its creditors (or any class of them). A scheme is not a formal insolvency process and can be used in both solvent and insolvent contexts. As long as a scheme involves a compromise, the company and the required majority of its creditors may agree a wide range of matters between themselves, binding minority dissenting creditors.

A scheme must be approved by creditors constituting 75% by value as well as 50% by number in each affected class of creditors. For this purpose, creditors must be divided into classes of persons of similar rights who could consult together with a view to their common interest. The sanction of a scheme by the Court is also required once the relevant classes have approved the scheme before it becomes effective. However, unlike a Chapter 11 plan in the US, dissenting creditors cannot be crammed across classes.

Schemes allow the compromise of one (or more) classes of creditors, and so can be used to surgically cram dissenting creditors within a syndicated facility or within a class of notes or bonds while avoiding an all-encompassing insolvency proceeding.

An English scheme of arrangement is a popular restructuring tool used to compromise creditor claims in large international work-outs. In this article we review the jurisdictional issues the English Courts have considered in cross-border schemes in the past 13 months. The six recent schemes covered provide an insight into the process the Court will go through in accepting jurisdiction in cases of foreign companies, debts and/or creditors.

Jurisdiction in relation to foreign companies

An application for a scheme may be made by a "company". The term "company" in this context means any company liable to be wound up under the Insolvency Act 1986 (UK), including a foreign company (which can be wound up on the basis that it is an unregistered company). In deciding whether to accept jurisdiction to sanction a scheme, the Court will consider: (i) whether the company has a "sufficient connection" with England; (ii) whether the scheme will achieve a substantial effect in the foreign jurisdictions in which the company conducts significant business; and (iii) where the company has creditors in the EU, whether the English Court's jurisdiction to sanction the Scheme is limited by the EU Judgments Regulation. The location of a company's "centre of main interests" (or COMI) – the touchstone for the allocation of jurisdiction for the opening of insolvency proceedings within the EU – forms no part of the jurisdictional test for the approval of a scheme (although see the comments below in relation to the Noble Group scheme).

In *Re Stripes US Holdings Inc* [2018] EWHC 3098, the Court was asked to sanction a scheme in relation to a Delaware company, Stripes US Holdings Inc **(SUSHI)**. SUSHI's parent was Steinhoff Europe AG (part of the South African based global retail group), and its only significant asset was shares in Mattress Firm Holding Corp (the leading retailer of mattresses in the US). Prior to the launch of the scheme in the UK the Mattress Firm subsidiaries filed for protection under Chapter 11 of the US Bankruptcy Code with the intention of consummating a sale in a short timeframe (to take advantage of Black Friday sales). However, in order for Mattress Firm to raise new debt SUSHI needed to be cleansed of its existing indebtedness, including a $200m credit facility governed by English law. The scheme proposed to swap the debt of SUSHI for new instruments issued by its parent, Steinhoff.

The scheme was approved by all lenders under the credit facility that were present and voting at the scheme meeting (representing by value 92.46% and by number 61.29% of all entitled creditors). The Court was asked to sanction the scheme on this basis.

SUSHI was a foreign (unregistered) company and therefore eligible to be wound up in England satisfying the first "hard" jurisdiction question.

The Court then turned to its jurisdiction over the scheme creditors, certain of which were incorporated in EU member states other than the UK. The EU Judgments Regulation provides a framework for the regulation of jurisdiction and the recognition of judgements in civil and commercial matters among EU member states. The default position under the Regulation is that defendants domiciled in an EU member state should be sued in that member state. There is considerable judicial uncertainty as to whether English schemes fall within the scope of the Regulation. If they do, an English scheme of arrangement amounts to the company suing its EU creditors in England. Rather than decide whether the Regulation applies to schemes, Courts have instead assumed that the Regulation will apply, and then considered the application of exceptions that would give English Courts the jurisdiction to sanction a scheme in relation to EU creditors. In Stripes US, the Court relied on the exception in Article 8 of the Regulations (commonly relied on in cross-border schemes), namely: where a foreign EU creditor is one of a number of creditor defendants within a class, in order to avoid risk of irreconcilable judgments in the case of closely connected claims, that foreign EU creditor may be sued in England where any one of the other creditor defendants is domiciled in England. Six of the 31 scheme creditors were domiciled in England and the Court accepted jurisdiction over the foreign EU creditors on this basis.

Courts have held that if claims that are the subject of the scheme are governed by English law then this should satisfy the requirement for a "sufficient connection" with England.

As a general principle of international law, a variation of contractual rights in accordance with the governing law of the contract done by the court of that law should be given effect in other countries. On that basis, Courts have held that if claims that are the subject of the scheme are governed by English law then this should satisfy the requirement for a "sufficient connection" with England. In Stripes US, the $200m credit facility that was the subject of the scheme was governed by English law and accordingly the "sufficient connection" test was satisfied.

The final jurisdictional issue was whether, in sanctioning the scheme, the English Court would "affront comity" with Courts in the US or in some way cut across the jurisdiction under Chapter 15 of the US Bankruptcy Code. The Court referred to evidence from an expert in US law which considered that the scheme would likely be recognised and given effect in the courts of the United States in forming the view that it was not cutting across the jurisdiction of the American courts. Indeed, the US Court has on a number of other occasions recognised and given effect to English schemes of arrangement in respect of companies incorporated in the US where the debt is governed by English law.

SUSHI subsequently obtained an order under Chapter 15 in the US Bankruptcy Court for the District of Delaware recognising the scheme as a foreign proceeding and granting related relief.

In *Re Noble Group Ltd* [2018] EWHC 3092 the Court needed to consider whether it had jurisdiction to sanction a scheme proposed by a Bermudan company which had taken steps to transfer its COMI from Hong Kong to England. The Company also intended to seek recognition of the English scheme in the US under Chapter 15 of the US Bankruptcy Code. The debts the subject of the scheme included 2018 Notes, 2022 Notes and a revolving credit facility, all governed by English law, and 2020 Notes governed by New York law.

The scheme proposed the release of claims of the scheme creditors in return for new instruments to be issued by newly-incorporated related companies that would also take a transfer of the assets of the existing Noble group. The scheme was approved by the statutory majorities and so the Court was asked to sanction the scheme.

In considering the questions on jurisdiction, the Court distinguished the "sufficient connection" test from the issue of where the scheme company had its COMI, while at the same time recognising that some of the same factors relevant to establishing the shift in COMI to England are likely to also be relevant to demonstrate a "sufficient connection" to that jurisdiction. This is particularly so given that "sufficient connection" is bound up with the question of whether the scheme is likely to be recognised in other relevant jurisdictions, which may depend on the

view the recognising Court takes of the location of the company's COMI (e.g. where such Court is applying UNCITRAL Model Law principles). Accordingly, the Court relied on factors associated with the shift in COMI to England (including the shift of the head office and centre for restructuring negotiations to London), as well as the English governing law of the majority of the debts and the strong support for the scheme in finding that there was a sufficient connection with England to justify exercise of the scheme jurisdiction.

The Court then considered whether it could be satisfied that the scheme would achieve a "substantial effect" in the foreign jurisdictions and the Court would not be acting in vain in sanctioning the scheme. The Court noted (among other factors) that the vast majority of international creditors supported the scheme (so the likelihood of foreign challenge was slight), an identical scheme was being promoted in Bermuda, and Noble had sought recognition of the schemes under Chapter 15 of the US Bankruptcy Code and/or principles of comity. In that regard, the Court relied on expert evidence from a former judge of the US Bankruptcy Court for the Southern District of New York, expressing the clear view that a US Bankruptcy Court would enter an order granting effect to the scheme in the United States.

The Company adduced evidence that 13 noteholders (with claims between 18.2% and 22.5% of the total scheme claims) were domiciled in England and accordingly, consistent with the SUSHI scheme, Article 8 of the EU Judgments Regulation would be engaged and satisfied. The Court was therefore satisfied that it was appropriate in the international context to exercise its discretion to sanction the scheme.

Finally, the English Court recently sanctioned a scheme in respect of Agrokor d.d., a giant Croatian food conglomerate. The financial difficulties of the group were well-publicised and in 2017 the company commenced extraordinary administration (EA) proceedings in Croatia. These proceedings were not included in Annex A of the Recast EU Insolvency Regulation so did not receive automatic recognition in England. They were however recognised in England under the Cross Border Insolvency Regulations 2006 and in the US under Chapter 15 of the US Bankruptcy Code. The ultimate goal of the EA proceedings was to restructure the obligations owed by Agrokor to creditors through a settlement plan under the EA law. The settlement plan was approved by the Croatian Court in 2018. The plan required the novation and amendment of a €1bn term facilities agreement governed by English law. Unanimous consent to the novation and amendment was required but was not forthcoming. This posed an issue for Agrokor: an English Court would be likely to refuse to enforce the Croatian plan as it relates to English law debts on the basis of the "Gibbs rule" which requires English law-governed obligations to be varied or discharged in accordance with English law. Accordingly, the company proposed the novation and amendment be effected by way of an English scheme of arrangement.

99.9% by value and 97.92 % by number of scheme creditors (being lenders in the relevant facilities) voted in favour of the scheme. The Court was then asked to sanction the scheme. Agrokor argued that the Court had jurisdiction for reasons similar to those considered in the SUSHI (and other) schemes, namely: (i) that the foreign (i.e. Croatian) company was eligible to be wound up in England as an unregistered company; (ii) the requirement that there be sufficient connection with England is satisfied by the fact that the facilities agreement is governed by English law; and (iii) that Article 8 of the EU Judgments Regulation can be relied on because there is at least one creditor domiciled in England and it is expedient that the claims be heard together. In order to show the scheme would be likely to have a substantial effect, Agrokor obtained expert evidence as to Croatian law which indicated that an order sanctioning the scheme would likely be recognised in Croatia, whether under the EU Judgements Regulation, the Rome I Regulation or under Croatian private international law. The Court sanctioned the scheme on 28 February 2019.

The ultimate goal of the EA proceedings was to restructure the obligations owed by Agrokor to creditors through a settlement plan under the EA law.

Jurisdiction in relation to foreign debt

As alluded to in the context of the Noble scheme, the English Courts will sanction a scheme for foreign debts where the Court is comfortable that the scheme is likely to be given effect in the jurisdiction of the laws that govern the debts.

In *Re Avanti Communications Group Plc* [2018] EWHC 653 (Ch) the applicant was an English-incorporated company which provided fixed-satellite services in Europe, the Middle East and Africa. The scheme proposed a debt-for-equity conversion of 2023 Notes. The notes were governed by New York law and, in their original form, included a US jurisdiction clause. In advance of the scheme, however, the holders of the notes were asked to consent to an amendment to the notes which provided that proceedings may be exclusively instituted in the Courts of England. The consent solicitation was successful and Avanti obtained an expert opinion to the effect that, as a matter of New York law, the amendment to the jurisdiction clause was effective to confer jurisdiction on the English court in relation to the scheme.

All scheme creditors present and voting at the scheme meeting approved the scheme (representing approximately 98.3% of all scheme creditors). Accordingly, the Court was asked to sanction the scheme. The company being incorporated in England meant the Court did not need to consider whether the company was capable of being wound up in England, or whether there was a sufficient connection with the jurisdiction. In considering the impact of the EU Judgments Regulation, an exception in Article 27 was relied on which allows for jurisdiction clauses to confer jurisdiction on the courts in a particular state (as had been amended via the consent solicitation). The concern with the usual reliance on Article 8 was that the nature of the 2023 Notes was such that the company could not be exactly sure who held the debt at any given moment, and therefore whether there would be a creditor domiciled in England for the purpose of the exception. As it transpired, there were at least 3 UK domiciled creditors and so Avanti was able to rely on Article 8 (as occurred in SUSHI) and Article 27.

In order to satisfy the Court as to the effectiveness of the scheme in practice in binding opposing noteholders to the amended terms, Avanti made the scheme conditional upon Chapter 15 recognition in the US and presented an expert report that the scheme would likely be recognised and given effect in the US. The Court sanctioned the scheme on 26 March 2018.

A similar approach was taken in *Re House of Fraser (Funding) Plc* [2018] EWHC 2663 (Ch). The case involved an English company with scheme debts governed by English and New York law. In advance of the commencement of the scheme process, the company amended the jurisdiction provisions in the debt documents to provide for submission by all of the parties to the jurisdiction of the English and Scottish Courts (in addition to US Courts). The scheme was approved by all creditors present at the meeting (representing 89% by value of all scheme creditors) and the Court sanctioned the scheme on 25 July 2018. Unfortunately, the group failed to secure required funds from prospective investors and consequently filed for administration on 10 August 2018, only to be acquired in a pre-packaged deal by discount sports retailer Sports Direct for £90m a few hours later.

As a matter of English law, any scheme creditor who has lodged a proof of debt in the administration of LBIE has submitted to the jurisdiction of the English Court for all purposes relating to the administration.

In *Re Lehman Brothers International (Europe) Ltd* [2018] EWHC 1980, the company's joint administrators sought to bring outstanding litigation to an end and facilitate the distribution of a surplus in excess of £6bn by cramming down the minority of unsecured creditors who did not agree with their proposed method of distribution. The landmark judgment includes a useful review of the law relating to the composition of classes, in particular the distinction between differing rights (which could split a class) and differing interests (which should not). From a cross-border perspective, the Court considered two issues of interest: (i) the impact of the EU Judgments Regulation; and (ii) whether the scheme would be given and achieve substantial cross-border effect. In following the well-trodden path, the Court assumed (without deciding) that the Judgments Regulation applied and

then turned to whether jurisdiction could be found within its provisions (i.e. through application of the relevant exclusions). Article 8 was again relied on because approximately 11% by number and 5% by value of the scheme creditors with admitted claims were domiciled in England. The Court also applied the exception in Article 26(1) of the Regulation, which provides that a court of a Member State before which a defendant enters an appearance shall have jurisdiction over the defendant. As a matter of English law, any scheme creditor who has lodged a proof of debt in the administration of LBIE has submitted to the jurisdiction of the English Court for all purposes relating to the administration. Any relevant creditors who had not lodged a proof in the administration were excluded from the scheme.

In considering whether the scheme would satisfy the “substantial effect” test, the Court noted that LBIE had applied to the US Bankruptcy Court for an order recognising the Scheme under Chapter 15 of the US Bankruptcy Code. Regardless of the Chapter 15 recognition, the Court held that the scheme would plainly achieve a substantial effect on the basis that creditors should not be able to enforce their statutory interest entitlements in the English administration of an English company under English law in any jurisdiction other than England, with only a small proportion of the surplus situated outside of England. The Court sanctioned the scheme on 18 June 2019.

Conclusion

The cases in this article demonstrate the practical utility of English schemes of arrangement in large cross-border restructurings and insolvencies.

In particular, the English Courts have shown flexibility in exercising their jurisdiction to sanction foreign schemes – the barriers to entry for large foreign companies with sufficient connections to England and a diverse international creditor-base are relatively low.

The English Court of Appeal’s recent decision in the OJSC Bank of Azerbaijan case (*Bakhshiyeva v Sberbank of Russia* [2018] EWCA Civ 2802) upholding the Gibbs rule means that English schemes – perhaps used in parallel with foreign restructuring measures or plans – are likely to continue to remain a requirement for the compromise of English law debts of a foreign company. It remains to be seen whether the Gibbs rule – which has been heavily criticised among the international restructuring community as being at odds with the general global trend towards modified universalism – will ultimately be considered by the UK Supreme Court. If so, it will be interesting to see whether the UK’s highest court of appeal will uphold or overturn the *Gibbs* rule – or, even if it is minded to take the view that the rule is anachronistic and has no place in the modern world of large-scale multi-jurisdictional restructurings, whether it considers that the rule can only be abolished by the legislature.

It is not expected that Brexit will impact the attractiveness of English schemes of arrangement for foreign companies. Assuming that the Judgments Regulation will cease to apply to the UK following Brexit (which remains unresolved at the time of writing), however, the issues encountered to date in relation to the application of the Judgments Regulation will be put beyond doubt: the Judgments Regulation will not apply to schemes. In the case of schemes relating to foreign companies, difficult questions may then arise in relation to jurisdiction and the recognition of English court-sanctioned schemes. For those reasons, it may be that there will be heightened emphasis post-Brexit on the expert evidence adduced to the English Court in the course of the scheme approval process as to whether or not a scheme will be recognised in the jurisdiction of incorporation of the debtor (and potentially other key jurisdictions), as a matter of private international law. That said, the effectiveness of schemes to date typically has not been blighted by a lack of recognition in other jurisdictions and it is perhaps unrealistic to suggest that Brexit will make any difference in that respect.

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Re OJSC International Bank of Azerbaijan [2018] EWCA Civ 2802

Bernie Walrut and Safiyya Khan in Sydney and Matthew Thorn in London

In the October International Restructuring Newswire we published an article on the High Court's ruling in *Gunel Bakhshiyeva (in her capacity as the Foreign Representative of The OJSC International Bank of Azerbaijan) v Sberbank of Russia & 6 Ors* [2018] EWHC 59 (Ch). In December 2018 the Court of Appeal unanimously upheld the High Court ruling. In this article we look again at the "rule in Gibbs" and provide an update on the Court of Appeal decision.

Despite ongoing criticism of the rule in *Gibbs & Sons v Sociětě Industrielle et Commerciale des Mětaux* (1890) 25 QBD 399 (**Gibbs**), English Courts have again confirmed that English law-governed debt cannot be discharged under a foreign insolvency proceeding unless the creditors have voluntarily submitted to that proceeding. The rule provides certainty to parties that choose English law that their contracts will not be modified or extinguished by any law other than the one they chose. Supporters argue that a creditor in the London financial markets may be less likely to trade with a foreign debtor if those English debts could be compromised by foreign restructuring measures not recognised in the EU.

The criticisms of Gibbs have centred on the conflict between its rule and the principle of modified universalism which strives for a unitary insolvency proceeding applying to all the assets and liabilities of the debtor world-wide. Proponents of universalism point to the practical benefit of providing distressed companies the opportunity to restructure under a single set of rules, without the cost and uncertainty of proceedings in different jurisdictions. The principle has formed the basis of much cross-border cooperation in insolvency matters and is given effect in a number of key jurisdictions, for example: in the EU, the EC Insolvency Regulation allows English law-governed debts to be modified by applicable EU proceedings; and, in the US, Chapter 15 of the US Bankruptcy Code enables US law-governed debts to be modified by foreign proceedings.

In the latest development in the OJSC case, the International Bank of Azerbaijan (**IBA**) made an application for an indefinite debt moratorium under an Azeri restructuring proceeding. The proceeding was recognised by the High Court as a main proceeding under the *Cross Border Insolvency Regulations 2006* (**CBIR**), giving rise to an initial moratorium that prevented creditors from commencing or continuing any action against the IBA in England. The application to extend the moratorium essentially sought to restrain certain creditors (that did not participate in the Azeri restructuring proceeding and did not submit to the jurisdiction of the Azerbaijani Court) from pursuing their claims in England once the Azeri restructuring proceeding had come to an end.

The Appellant argued that the application of the rule in Gibbs, was limited by the powers under Article 21 of the CBIR which provide that an English Court may grant any appropriate relief necessary to protect the interests of creditors (in effect, asking the Court to "sideline or circumvent the established common law rights of the English creditors by an appeal to the principle of modified universalism"). The Court assessed whether that moratorium was: 1) necessary to protect the interests of creditors; and 2) an appropriate means of achieving that protection.

The Court found that neither of those conditions were satisfied. Lord Justice Henderson said that extending the moratorium was not necessary to protect the interests of IBA's other creditors as they had already received everything to which they were entitled under the Azeri restructuring proceeding (which was at an end). The Court also noted that:

The criticisms of Gibbs have centred on the conflict between its rule and the principle of modified universalism which strives for a unitary insolvency proceeding applying to all the assets and liabilities of the debtor world-wide.

1. it was material that the IBA could have run a parallel scheme of arrangement but chose not to do so;
2. there is nothing in article 21 of the CBIR to suggest that the procedural power to grant a stay could substantively circumvent the creditors' English law rights; and
3. extending the moratorium after the restructuring proceeding terminated would be inconsistent with the 'procedural and supportive' role of the Model Law.

The Court also acknowledged the adoption by UNCITRAL in July 2018 of a new model law on the recognition and enforcement of insolvency-related judgments, which specifically includes a judgment (i) confirming or varying a plan of reorganisation or liquidation, (ii) granting a discharge of the debtor or of a debt, or (iii) approving a voluntary or out-of-court restructuring agreement. It is now for the UK to implement the new model law if – and in such form – it sees fit, which could provide much-needed legislative certainty on the matter.

The Appellant has applied for permission to appeal and reserved her right to challenge the Gibbs rule. We do not know whether the decision will be taken to the Supreme Court or whether the parties will settle.

Whilst this continues to be a dispute to watch, for the time being foreign entities running restructuring proceedings outside of the EU ought to consider whether it would be appropriate to run a parallel scheme of arrangement in England to compromise English debts (as was done in the recent case of *Agrokor d.d.* where a parallel scheme was used to restructure English debts within Croatian insolvency proceedings) or otherwise run the risk of creditors attempting to unwind restructuring efforts carried out in foreign jurisdictions.

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Seismic Shift for Lenders to the Resource Sector: Supreme Court of Canada rules that a company's environmental liability can rank in priority to secured debt

Aditya Badami and Daniel Mills

Summary

A recent Supreme Court of Canada decision commonly referred to as *Redwater* marks a seismic shift in Canadian insolvency law. The case is causing uncertainty throughout Canada's secured lending community, which now faces new and unexpected risks.

In *Orphan Well Association v Grant Thornton Limited*, 2019 SCC 5 (***Redwater***), a majority of the Supreme Court of Canada ruled that provincial legislation governing the abandonment and remediation of oil and gas assets and associated sites was effective in spite of federal bankruptcy and insolvency legislation governing trustees' rights and duties in relation to environmentally-impacted property. The decision also dealt with the priority of repayment to creditors out of a bankrupt estate.

Based upon the Supreme Court's decision, an insolvent company's environmental liabilities, which may engulf the realizable value of the insolvent estate, can have priority over any distributions to secured creditors. The decision has raised the spectre of zero-recovery insolvencies, even for senior secured lenders.

While the *Redwater* decision was made in the context of oil and gas remediation, the decision will have significant implications in a variety of industries where environmental regulation is a significant issue, including mining and manufacturing.

Background

The legislation

The *Oil and Gas Conservation Act* and *Pipeline Act* form part of the regulatory scheme that governs Alberta's oil and gas sector. Under that legislation, industry participants must be licenced to begin operation. Those licences are issued by the Alberta Energy Regulator (the **Regulator**). One of the objectives of the licensing scheme is the management of environmental risks. Attaching to each licence are various "end-of-life" obligations that require licence holders to remediate properties once they have reached the end of their useful lives or been abandoned.

To ensure that these obligations are met, the Regulator imposes strict limitations on the transfer of licences. In particular, the Regulator will not permit a transfer where the effect of that transfer would be to reduce one of the parties' asset value to environmental liabilities ratio to less than two (2.0).

The *Bankruptcy and Insolvency Act* (**BIA**) is one of Canada's primary insolvency statutes. The BIA prescribes a "waterfall" of repayment obligations, the effect of which is to rank various kinds of debt and pay out according to the priority scheme set out in section 136 of the BIA.

Facts

The oil and gas assets in this case were formerly owned and operated by *Redwater*, a publicly traded corporation with operations in central Alberta. Prior to its bankruptcy, *Redwater* possessed 84 wells, 7 facilities and 36 pipelines, each of which was subject to a licence. *Redwater* was also party to a secured loan agreement, under which it owed approximately $5.1 million. In mid-2014, *Redwater* encountered financial difficulties and eventually became bankrupt, at which time Grant Thornton Limited (**GTL**) was appointed trustee in bankruptcy and initiated a liquidation sales process.

On learning of *Redwater*'s insolvency, the Regulator sent a letter reminding GTL of *Redwater's* outstanding environmental

Under Canadian law, where provincial legislation conflicts with federal legislation, the provincial legislation will be deemed inoperative to the extent of the conflict.

obligations. The Regulator advised that, under Alberta legislation, the trustee in bankruptcy was a deemed licensee, and therefore subject to the same end-of-life obligations as had been the bankrupt licensee – in this case, *Redwater*. The Energy Regulator further advised that, per its licence transfer policy, it would deny any application to transfer the valuable licences pending satisfaction of the end-of-life obligations or the posting of security in the full amount of such obligations, as *Redwater's* asset to liability ratio was currently less than one. Denial of license transfers would render *Redwater's* assets effectively unsaleable, as the assets can only be exploited lawfully with the regulatory licenses in place.

GTL responded that it was under no such obligation. Specifically, it asserted that it was entitled under the BIA to disclaim assets with negative realizable value, and advised that it had done so in respect of 107 of *Redwater's* licensed properties. GTL argued that it had no responsibility with respect to *Redwater's* former environmental obligations, and that any attempt by the Regulator to block the transfer of the licences for assets that had positive net realizable value would be a violation of the BIA.

At trial, the Alberta Court of Queen's Bench agreed with GTL's argument and concluded that the Alberta legislation was inoperative to the extent that it conflicted with GTL's rights under federal bankruptcy law. A majority agreed at the Court of Appeal of Alberta. The Regulator and the Orphan Well Association appealed.

Decision

At the Supreme Court of Canada, a 5-2 majority overruled the Court of Appeal's decision. Specifically, the Court held that *Redwater's* and GTL's obligations arising under the Alberta legislation remained effective and were not affected by the provisions of federal bankruptcy legislation.

Under Canadian law, where provincial legislation conflicts with federal legislation, the provincial legislation will be deemed inoperative to the extent of the conflict. In applying this doctrine to the facts of the case, the Court considered two primary questions:

1. Do the provisions of federal bankruptcy legislation permit trustees in bankruptcy to disclaim environmental obligations of the kind imposed under the Alberta Legislation?

2. In obliging trustees in bankruptcy to satisfy outstanding environmental obligations prior to transferring oil and gas licences, does the Alberta legislation (and the Regulator's actions thereunder) interfere with secured creditors' priority rights under federal bankruptcy law?

Subsection 14.06 and the power to disclaim

On the first question, GTL argued that federal bankruptcy legislation allows the trustee in bankruptcy to reject or "disclaim" any asset of the bankrupt estate, along with any environmental liabilities that might attach to that asset. The Court rejected this argument. In reaching this conclusion, the Court relied on specific language in the BIA – which makes no reference to absolving the bankrupt's estate from liability – and parliamentary evidence from the time of the subsection's enactment. The section of the BIA in issue was interpreted as apply only to the personal liability of trustees.

Interference with the BIA priority scheme

On the second question, the Court again found for the Regulator. Here the central question was whether the Regulator's actions had the effect of creating an unsecured "claim provable in bankruptcy."

Where an unsecured claim provable in bankruptcy exists, it will be subject to the distribution scheme set out in section 136 of the BIA, and unless otherwise indicated, will be subordinated to the interests of secured creditors. In seeking to enforce the end-of-life obligations ahead of the senior secured debt, GTL argued that the Energy Regulator was effectively seeking to enforce a claim against the estate, thereby interfering with the priority scheme set out in the BIA.

The Court took the opportunity to provide clarification and elaboration with respect to the three-part test from *Newfoundland and Labrador v*

AbitibiBowater Inc., 2012 SCC 67, [2012] 3 S.C.R. 443 (***Abitibi***), which is used to determine whether a regulator is asserting a claim provable in bankruptcy.

The test from *Abitibi* can be summarized as follows. For an environmental obligation owing to a regulator to meet the definition of a "claim provable in bankruptcy":

1. There must be a debt, a liability or an obligation to a creditor;
2. The debt, liability or obligation must be incurred before the debtor becomes bankrupt; and
3. It must be possible to attach a monetary value to the debt, liability or obligation.

In reaching its conclusion, the Supreme Court's majority clarified parts one and three of the *Abitibi* test. With respect to step one, the Court explained that a regulatory body does not become a creditor simply by demanding satisfaction of an environmental obligation. Rather, it must be determined whether the body is acting in a *bona fide* regulatory capacity, or whether it is simply seeking to collect an amount owing. In this case, the Court held that it was clear that the Regulator was acting in a *bona fide* regulatory capacity to enforce a pre-existing regulatory scheme. This was not a debt collection, the Court held, but an effort to ensure the satisfaction of a "public duty". As such, the Regulator's enforcement of the end-of-life obligations could not render it a creditor under part one of the test.

The Court went on to hold that the third prong of the *Abitibi* test was likewise unmet. The Court found that it could not attach a monetary value to the obligation imposed by the Regulator. The Court emphasized that the relevant question was whether it was "sufficiently certain" that the Energy Regulator would complete the work, and that a corresponding debt to the Regulator for doing so would "come to pass." The Court found that it was not the Regulator who might perform the work, but an independent not-for-profit organization: the Orphan Well Association. Further, the Court found that it was not sufficiently certain when, if at all, the work would be completed, given the rapidly rising rate of orphan wells, and the limited capacity of the Orphan Well Association.

Having determined that the Regulator's orders did not constitute claims provable in bankruptcy, those orders were unaffected by federal bankruptcy legislation or any claims of secured creditors.

In the result, the Supreme Court directed that funds held in trust by GTL from sale proceeds of *Redwater* assets be used to address the outstanding environmental obligations, as opposed to being distributed to the company's first secured creditor.

The path forward

The practical implications posed by *Redwater* are far-reaching for lenders, energy industry participants, and regulators. Secured lenders are left with significant uncertainty about what environmental obligations, if any, will have to be paid before any proceeds of realizations can be used to repay the ranking creditors.

Energy industry financing will, no doubt, face growing pains as the industry adapts to the new legal framework that would enforce a "polluter's creditors" pay model, as opposed to the "polluter-pay" approach to environmental harm that was more typically associated with Canadian resource extraction.

In particular, lenders will no doubt adjust their lending practices to account for end-of-life obligations that, until now, were thought to be subordinate to secured debt. Under the common law, end-of-life obligations attaching to oil and gas licences are effectively super-prioritized in the bankruptcy context. Accordingly, lenders are likely to be more hesitant in extending financing to small-to-medium-size energy industry participants or will require bonding or other forms of up-front commitments to satisfy the prospective end of life obligations. Certainly any new financing is likely to have just become more costly as a result of *Redwater*. Secured lenders may also wish to modify the loan terms to which they earlier bound themselves to protect against this new risk. Lenders are also likely to reserve greater rights for themselves to prevent borrowers from acquiring marginally-producing assets.

Another implication of the decision concerns the utilization of the bankruptcy process. In particular, with respect to loans extended in the pre-*Redwater* world, lenders may elect not to commence formal bankruptcy proceedings where the end-of-life obligations attaching to oil and gas properties outweigh the potential value of the associated assets. Similarly, trustees in bankruptcy or receivers may be unwilling to accept mandates where their efforts will not be able to provide value to the estates over which they are appointed (let alone when their own fees may not be first-secured given the Supreme Court's ruling). Insofar as these possibilities exist, so too does the possibility that the *Redwater* decision will ultimately lead to, perversely, an increase in the number of orphan wells, as insolvent companies leave behind both their spent properties that have high remediation costs relative to their value and their valuable properties due to the inability to sell the valuable properties separate from the spent properties.

Another potential outcome is that that the Regulator will adjust its licence transfer policy to demand a higher asset to liability ratio before permitting transfers. While this change will not be directly attributable to the *Redwater* decision, the Regulator may now have a greater impetus to limit instances such as the one considered in *Redwater*. Moreover, in the long-term, while financing for regulated industries in the extractive sector may be stymied, the decision may afford regulators with greater flexibility and a greater ability to address environmental concerns in the context of insolvent companies whose insolvency leaves behind untended environmental hazards. Indeed, on the day the *Redwater* decision was released, the Regulator press released its intention to build a new regulatory "framework".

The case also poses implications for regulated industries in Canada beyond oil and gas; the Supreme Court's ruling bears upon any industry in which environmental remediation is a regulated and obligatory activity. *Redwater* suggests that the obligation to remediate not only survives a formal insolvency but must be addressed ahead of the claims of secured creditors, including lenders, municipalities, and lien claimants.

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Impact of the Australian Banking Royal Commission on Insolvency Professionals

Scott Atkins and Philip Charlton

In response to widespread public concern about systemic misconduct in the banking and financial services sector in Australia, a *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* was established in December 2017 by the Australian government. The Commission met throughout 2018 presided over by Commissioner Kenneth Hayne, a former High Court judge.

The final report of the Commission was released to the public on Monday 4 February 2019.

As predicted by many, Hayne delivered a detailed report containing a comprehensive set of recommendations across the Australian banking, financial advice, superannuation and insurance sectors (**FS sectors**) as well as recommendations on the key areas of organisational culture, governance and remuneration (**CG&R**) and on the conduct of regulation over the industry.

For the insolvency industry, Hayne's final report raises important matters in the areas of corporate governance (and the executive responsibilities that administrators and liquidators assume as statutory insolvency officials and as "gatekeepers" over the financial services industry); of directors' duties (in particular, the grounds for making claims against former directors on behalf of creditors); and the impact of a more aggressive enforcement culture adopted by regulators.

Hayne's approach

To understand Hayne's recommendations and link them to the specific context of insolvency, you have to understand the Commissioner's principled 'building block' approach in the way he has set out his report. His central objective in the final report is **to examine what can be done to avoid the misconduct in the FS sectors being repeated.**

He starts with some key observations that have guided the Commission's work. In the context of CG&R, he observes that:

- The misconduct was driven **by the relevant entity's pursuit of profit and also by the individual's pursuit of gain**, whether in the form of remuneration for the individual or profit for the individual's business (effectively, a feature of prevailing culture and governance)

Hayne identifies a number of important questions that will be the basis of any policy response to the misconduct and shortcomings in the FS sectors exposed during the Commission's hearings. On the subject of CG&R, he asks:

- What more can be done to **achieve effective leadership, good governance and appropriate culture within financial services firms** so that firms comply with *six basic norms of conduct?*
  - Obey the law
  - Do not mislead or deceive
  - Be fair
  - Provide services that are fit for purpose
  - Deliver services with reasonable care and skill
  - When acting for another, act in the best interests of that other

Hayne sees these six "very simple ideas" as being the real basis for the proper conduct of financial service entities. They also support a number of general rules that he outlines including, in the CG&R space, that **"culture and governance practices (including remuneration arrangements), both in the industry generally and in individual entities, must focus on non-financial risk[1], as well as financial risk".**

The Report's recommendations all relate to one or more of his key questions and reflect one or more of the

six simple ideas. This is especially so in his commentary and recommendations on CG&R.

In light of the above, Hayne's recommendations and supporting commentary are relevant not only, of course, to professionals working within FS sectors **but also to other professionals including the insolvency practitioner (IP).**

If the board does not have the right information, it simply cannot effectively challenge management and properly discharge its functions.

Insolvency practitioners' assumption of management responsibilities

An IP (such as an administrator) will take over responsibility for the running of an insolvent entity and in doing so owe a primary duty to creditors. The IP, in an administration or liquidation, has all the powers of the company and its directors.

In managing the entity, the IP will be principally assessing the entity's ability to operate as a going concern on a long-term basis. The focus will accordingly be on the financial or business aspects of the entity's activities (in other words, its financial risks). However, an IP cannot lose sight of the need for proper management of an entity's non-financial risk, as this will be important for the business' future sustainable life where reputation, brand value, recruitment capabilities and regulatory relationships (to name only a few) will play a big part in the entity's activities.

IPs therefore need to keep in mind Hayne's recommendations on CG&R and specifically his Recommendation 5.6: *all financial service entities should, as often as reasonably possible, take proper steps to assess the entity's culture and governance, identify any problems with that culture and governance, deal with those problems and determine whether the changes it has made have been effective.*

Hayne reiterated in his final report that directors (and by implication IPs) should ask:

- Is there adequate oversight and challenge of emerging non-financial risks?
- Is it clear who is accountable for risks and how they are to be held accountable?
- Are issues and risks identified quickly, referred up the management chain and then managed and resolved urgently? Or does bureaucracy get in the way?
- Is enough attention being given to compliance? Or is it just "box ticking"?

Although the time period may be short during which an IP is controlling an entity for the purposes of the administration or other insolvency process, this does not lessen the importance an IP should apply to matters of non-financial risk, accountability, good management practices and compliance generally.

Indeed, a focus on these matters as part of its investigation of the affairs of the insolvent entity may well give rise to information that could form a ground for making claims against former directors for dereliction of their duty.

Directors' duties and claims for breach

An IP will assess, on behalf of the creditor group, whether the former directors of the entity have complied with their legal responsibilities, and whether a claim for breach of director's duties might be feasible as part of the asset/cash recovery process within an administration or liquidation.

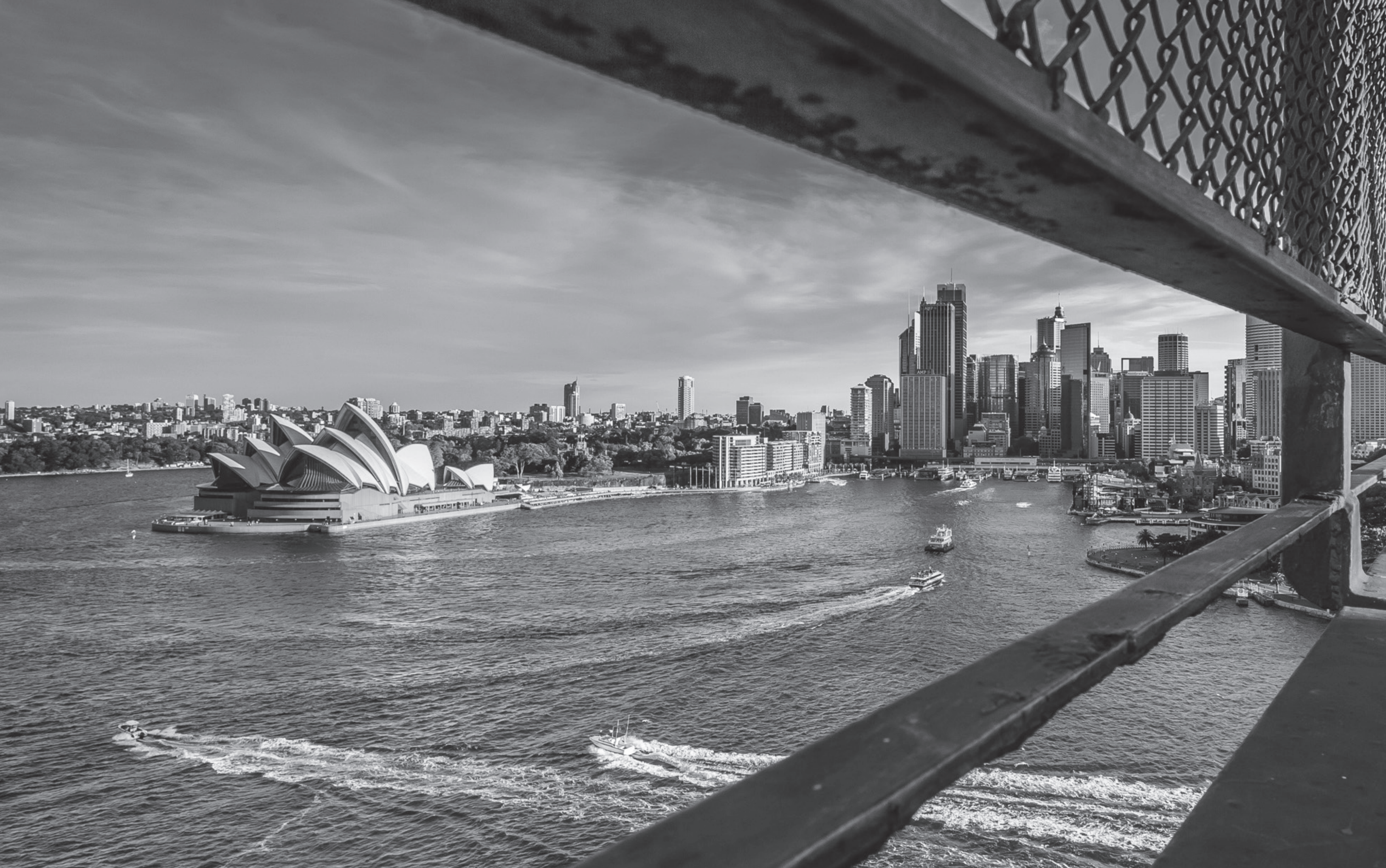
The ability to identify a potential breach in director's duties and the extent to which creditors may potentially benefit from a claim against the directors of an insolvent organisation is therefore an important element in the work of an IP.

When looking specifically at examples of directors' flawed behaviour in the conduct of their duties, Hayne honed in on **two very practical features of governance** that are critical to managing risk and that were **particularly lacking in a number of financial services entities**:

I. *The need for boards to get the right information about emerging non-financial risks*. This requires the board to:

   a. seek further or better information if what they have is deficient; and

   b. use that information properly in order to robustly challenge management's approach to managing these risks.



If the board does not have the right information, it simply cannot effectively challenge management and properly discharge its functions.

Hayne notes that the evidence before the Commission showed that boards frequently did not get the right information about emerging non-financial risks. He also emphasises the need for the *right* information and not more information – quality not quantity.

Hayne firmly lays the responsibility for getting the right information on boards and senior management.

II. *The need for boards and senior management to be clear who within the financial services entity was accountable for what.*

The evidence before the Commission showed frequent uncertainty or ignorance within financial service entities as to who was responsible for what actions or tasks. Such uncertainty destroys any form of effective accountability.

Clear accountability is intrinsic to good governance. It ensures that problems are resolved effectively. It fosters a culture where risks are managed soundly. It is accountability that determines what consequences must follow when things go wrong (and where credit is due where things go right).

These are matters of importance for any corporate entity. The consequences of not properly addressing these two needs can be, and were in the case of certain financial services entities, particularly adverse.

It follows, therefore, that where directors have failed in these particular fundamental responsibilities, then the question should be asked as to whether a breach of directors' duties has occurred.

Hayne's limited analysis of legal basis of directors' duties

Interestingly, Hayne does not spend much time in a detailed analysis on whether what happened in the FS sectors amounted to a series of breaches of directors' duties. Hayne did refer a number of examples of misconduct to the regulators for consideration as to whether criminal or civil proceeding should be pursued. Claims for breach of directors' duties may ensue as that consideration progresses.

This lack of legal analysis in the final report is, however, in keeping with Hayne's approach in his final report. Hayne distrusts any supposed benefit of additional complication in an already cluttered financial services law. In general, he has helpfully pointed out practical omissions and related circumstances that have led to significantly adverse outcomes for banks and their customers. But he

has generally avoided advocating for extensive law changes as a solution which suggests he sees more practical, behavioural-based solutions as being relevant to the problems in the FS sector (e.g., adherence to the six norms which, he says, are a necessary aspect of any good culture)

Hayne considers the legal duties of directors in a fairly brief section of the report that looks at the question of to whom directors' duties should be owed. In Australia, a key duty of a director is to exercise his/her powers "in good faith in the best interests of the corporation and for a proper purpose" and to exercise his/her powers with reasonable care and skill. In line with Hayne's view that the prudent management of non-financial risk is of equal importance to that of financial risk, he considers who the beneficiaries of those duties should be. He concludes that this is the corporation and that financial returns to shareholders, though important, are not the only matter to be considered. The interests of customers, employees and others associated with the company may also require consideration as well, depending on the circumstances.

Hayne concludes this piece by saying that the interests of key stakeholders (shareholders, customers, employees etc) are more likely to converge with the company's *long-term* financial advantage. And that long-term financial advantage is more likely to follow if the company conducts its business according to proper standards, treats its employees well and seeks to provide its shareholders with results that in the long run compare favourably with similar competitors.

Change in enforcement culture

Hayne has been critical of the financial regulators' approach and attitude towards the enforcement of laws that they administer.

The entrenched culture within the corporate regulator - the Australian Securities & Investments Commission (or ASIC) - of seeking to resolve conduct issues by agreement or negotiation (and, in particular, approaching that negotiation from the perspective of what the regulated entity is prepared to give) draws particular fire. This "*cannot be the starting point for a conduct regulator*" and Hayne continues by pointing out that *"compliance with the law is not a matter of choice"*. Public denunciation and punishment for wrongdoing is important as a deterrent and to clearly signify the community's views of, and position on, that wrongdoing.

Hayne therefore recommends that ASIC's approach to enforcement should start with the question of whether a court should determine the consequences of a breach – in other words, "Why not litigate?" ASIC has accepted this recommendation and is now in the process of adopting this changed attitude within its enforcement division.

Financial service entities can therefore expect, for the time being, a more aggressive approach on enforcement from regulators who are now displaying a stiffened resolve to apply and enforce the law. This will mean more claims and the possibility of financial damage and possibly even insolvency, especially where public denunciation through enforcement leads to the abandonment of the entity by its customers.

The recent passage in Australia of penalty legislation reflects the seriousness being applied to stiffening regulatory resolve. The new law increases maximum prison penalties for the most serious offences to 15 years. It significantly increases civil penalties for companies, now to be capped at AU$525 million, with maximum civil penalties for individuals increasing to AU$1.05 million. Significantly, the law also introduces, for the first time, a civil penalty (capped at AU$525 million) for breach of the primary obligation banks and other financial services licensees owe to all of their customers, that is 'to do all things necessary to ensure the financial services covered by the licence are provided efficiently, honestly and fairly'.

Relevant to this trend and as part of its response to Hayne's recommendations, ASIC has announced a set of five principles for litigating and which will guide the approach of its new (and ring-fenced) Office of Enforcement:

[1] By non-financial risk, we mean operational risk (the risk of loss arising from inadequate processes, people and systems or from external events), compliance risk (the risk of legal or regulatory sanctions, material financial loss or reputational loss arising from breaches of laws, regulations, rules, codes of conduct and other standards) and conduct risk (the risk of inappropriate, unlawful or unethical behaviour by employees of an organisation).

1. Where a possible breach of law is known to ASIC, ASIC will undertake an assessment and, if appropriate, conduct an investigation by reference to the facts and law. **Once ASIC is satisfied that breaches of law are more likely than not, it will ask itself: why not litigate?**

2. Any public interest in pursuing a (non-court) negotiated outcome is weighed against the clear benefits of a judgment and imposition of a prison sentence, civil penalty or other court-based outcome with a negotiated outcome pursued only where objective assessment weighs in favour of the negotiated outcome.

3. There is a focus on **both corporate accountability** and individual accountability particularly at executive and board level for breaches of the legislation administered by ASIC.

4. **Emerging technologies** are employed to enhance ASIC's enforcement capabilities and these technologies are monitored so ASIC keeps pace with advances in these technologies.

5. There is careful monitoring of, and an endeavour to pre-empt, budgeting and resourcing requirements.

In light of the change in approach reflected in these new principles, IPs need to be alive to the greater possibility of enforcement action leading to adverse consequences for an entity, especially when the IP has taken control of an entity, for example in an administration.

Enforcement action by a regulator may indeed be the precursor to directors' duties claims by an IP based on the behaviour that is itself the basis of the regulator's action.

In the final analysis, Hayne's recommendations and observations should make for compulsory reading by participants in the FS sectors and the professionals (such as IPs) that serve the sector. The position of IPs, at least in Australia, as "gatekeepers" who have a responsibility for the honest and efficient operation of the wider system, means IPs cannot ignore the implications of Hayne's views on the proper conduct of corporate governance, that conduct's effect on the enforcement of directors' duties and the greater likelihood of enforcement action by the financial regulators.

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