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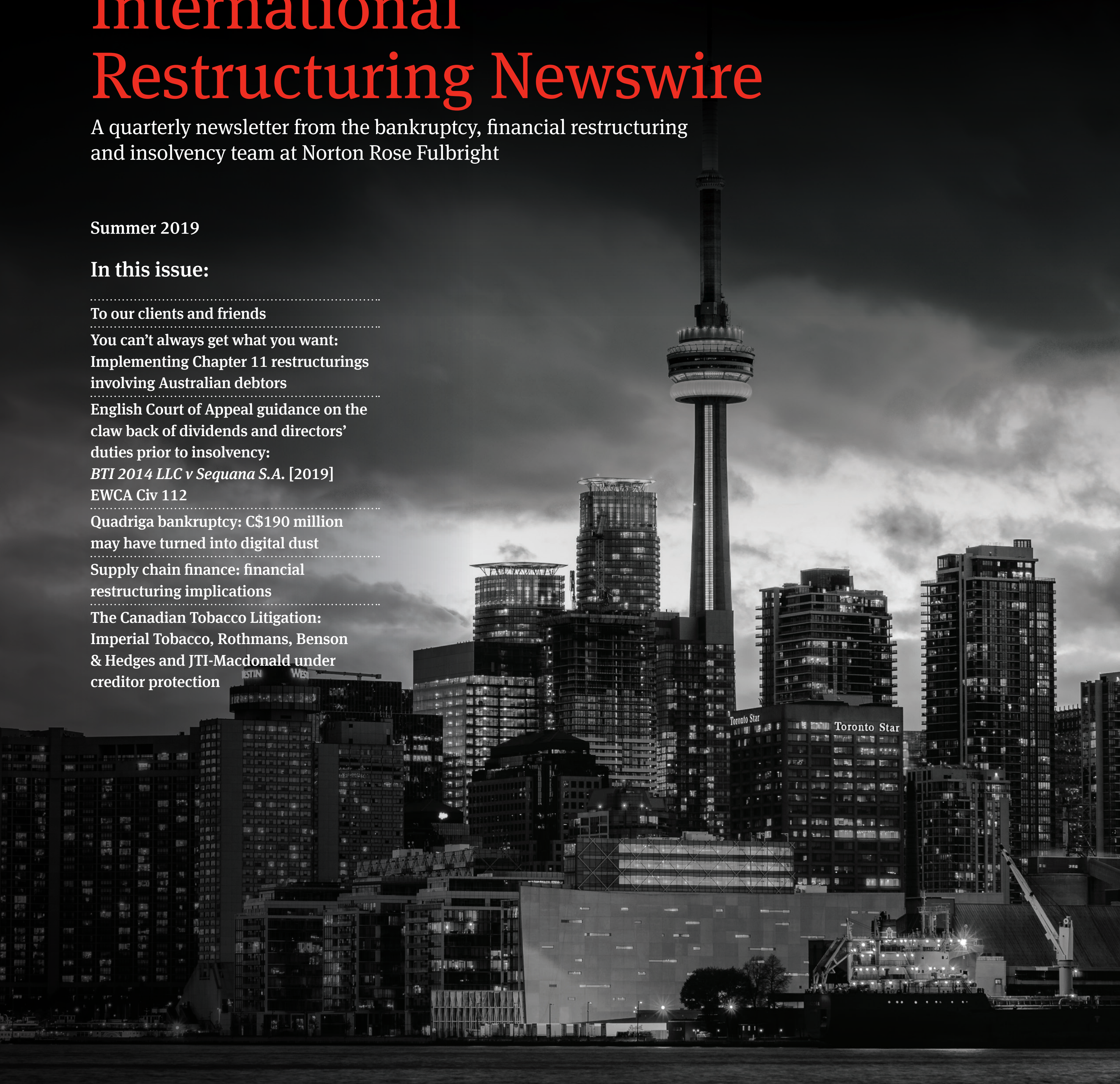
NORTON ROSE FULBRIGHT

International Restructuring Newswire

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

Summer 2019

In this issue:



Contents

International Restructuring Newswire

International Restructuring Newswire is published by Norton Rose Fulbright and is not a substitute for fact-specific legal counsel.

International Restructuring Newswire
Published by Norton Rose Fulbright – Summer 2019 – Issue 7

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To our clients and friends:

Welcome to the summer edition of the Norton Rose Fulbright *International Restructuring Newswire*. This issue features articles from the United Kingdom, Australia and Canada. In addition to focusing on cross-border insolvency issues, you will find of interest an article from Canada describing the risks entailed in doing business with a cryptocurrency exchange and an article from London on the restructuring implications of supply chain finance. And, in an article from Australia, we have a lively comparison of its voluntary administration with the US Chapter 11.

While on the subject of chapter 11, often times one hears criticism, particularly from other jurisdictions, that court supervised reorganizations in the US take too long and are too expensive. But that need not be the case. Prepackaged chapter 11 filings, or prepacks, are being used with increasing frequency and are faster than ever. We have seen recent prepacks in 2019 that have been completed, from filing to emergence, in less than a month. In fact, *Sungard Availability Services* filed a prepack on May 1 and had its plan of reorganization confirmed within 19 hours of filing and emerged from bankruptcy in less than two days. This case broke the previous prepack speed record of *FULLBEAUTY* Brands which took four days. While these two cases were extraordinarily expeditious, it is no longer unusual for a prepack to emerge from chapter 11 within a month or so of filing. Per a report from FTI, "eight of 15 filings that have exited chapter 11 via a plan of reorganization so far in 2019 were prepacks that, on average, took just 44 days from filing to emergence." While not every reorganization will have the overwhelming support of creditors – support that is necessary in order to implement a prepack – where there is such support, a prepack may be the route to a speedy and less expensive chapter 11 reorganization.

Good reading and all the best for the summer.

Howard Seife
Global Head
Financial Restructuring and Insolvency

In the news

April

Singapore: April 2 – 4, 2019

Lee Pascoe chaired the workshop at the INSOL International Regional Conference in Singapore on “Dealing with Cryptocurrency Assets in Insolvency.” She also spoke subsequently on a panel rounding up the current key issues in Fintech insolvency.

June

Sao Paulo, Brazil: June 4, 2019

Andrew Rosenblatt, Francisco Vazquez and Michael McCourt along with attorneys from Machado Meyer held a “Bank Training Day” in Sao Paulo. The team presented on cross-border restructuring to various Brazilian bankers.

Boston, MA: June 7, 2019

Francisco Vazquez participated on a panel on “The Impact of Trade Tariffs – How are they Impacting Companies and Creating Distressed Situations?” at the Association of Insolvency & Restructuring Advisors’ 35th Annual Bankruptcy & Restructuring Conference.

Barcelona, Spain: June 17, 2019

Scott Atkins was a panelist at the International Insolvency Institute Annual Conference in Barcelona. The panel was chaired by Professors Christoph Paulus and John Pottow and featured Professor Jay Westbrook, discussing “A Comparative Analysis of Forum Shopping.”

July

Singapore: July 12, 2019

Scott Atkins was a panelist at the Australian Bar Association’s National Conference – ‘Convergence’ – in Singapore. Scott discussed “Cross-Border Insolvency & Restructuring: New Frontiers in Singapore and Australia” with fellow panellists the Hon. Justice Jacqueline Gleeson of the Federal Court of Australia, Mei-Yen Tan of Oon & Bazul and Farid Assaf SC of the NSW Bar.

Melbourne, Australia: July 23-25, 2019

Scott Atkins, in his capacity as President of the Australian Restructuring Insolvency and Turnaround Association will be chairing the annual national conference of ARITA in Melbourne, Australia. The conference will include a keynote address from Mohsin Meghji, the CRO of Sears Holdings Corporation and David Kelly of PwC and lead special manager of Carillion in the UK.

August

Los Angeles, CA: August 21-23, 2019

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

September

Seoul, South Korea: September 26, 2019

Lee Pascoe is chairing the panel “Virtual Assets versus real insolvencies” at the IBA Annual Conference in Seoul.

October

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.”

Insolvency and Restructuring International

Lee Pascoe’s article “Digital currency exchanges, ICOs and insolvency: the story so far” was recently published in *Insolvency and Restructuring International* (Vol 13 No 1, April 2019) a publication of the International Bar Association’s Insolvency Section.

INSOL World

Scott Atkins and Jonathon Turner published an article in *INSOL World*, Quarter 1, 2019 entitled “The Ability of Insolvency Practitioners to Operate in Foreign Jurisdictions.” This article considers the licensing and regulation of insolvency practitioners and their regulation when working in cross-border matters in foreign jurisdictions.

Scott Atkins and John Martin published an article in *INSOL World*, Quarter 1, 2019 entitled “Modernising Insolvency in Myanmar: Opportunities and Challenges.” This article analyses the Myanmar Debtors Rehabilitation Bill which is the subject of ongoing work by Scott and John.

You can't always get what you want: Implementing Chapter 11 restructurings involving Australian debtors

Tim Mornane and Jeffery Black

It is perhaps a result of Australia's penal colony roots that its corporate insolvency and personal bankruptcy laws have leant more towards punishment rather than salvation. More likely, the lengthy absence of legislative support for a holistic culture of business rescue is simply a function of inheriting traditional English insolvency laws and keeping them for the first 100 years of the Australian Federation. Regardless, there has long been reticence on Australian lawmakers on both sides of the political spectrum to institute a Chapter 11 style regime in Australia or indeed undertake any deep reforms of the corporate insolvency regime.

The thought of having a debtor-in-possession style corporate restructuring regime in Australia has been seen as an anathema. The Financial System Inquiry Interim Report (July 2014) noted that:

> *"The [FSI] considers adopting [Ch 11] would be costly and could leave control in the hands of those who are often the cause of a company's financial distress."*

But, The Financial System Inquiry Final Report (November 2014) highlighted some elements of Chapter 11 that merited further assessment and since the time of that report, change has been afoot. As detailed in this publication over previous editions, several recent legislative changes arising from Australia's National Innovation and Science Agenda (November 2015), such as the introduction of a prohibition against the enforcement of *ipso facto* clauses in commercial contracts and the 'safe harbour' quasi-defence for insolvent trading, have taken Australian corporate insolvency laws a little closer towards the United States approach. These small, incremental changes have been aimed at encouraging Australian companies to engage earlier and more deeply with solvency issues and to take well-planned and reasonable risks to facilitate a company's recovery.

Adopting concepts from the Bankruptcy Code and tempering old English law principles is a feature of the increasing competition between Anglo and American legal and cultural influences in Australia. It is a phenomenon that has grown since the birth of Australia's modern corporate insolvency regime. It is also a reflection of the internationalisation of Australian businesses. From the cross-border insolvency perspective, the recognition of the globalisation of Australian businesses and the need for a modern approach to provide more effective and efficient mechanisms for dealing with cases of cross-border insolvency began with the adoption of the UNCITRAL Model Law (the "Model Law") through the *Cross-Border Insolvency Act 2008* (Cth) (the "CBIA") over 10 years ago.

Australia's trading relationship with the US

The US has long been one of Australia's top three trading partners despite the increasing prominence of Australia's regional Asian trading partners. According to Australian Department of Foreign Affairs and Trade statistics, the US remains Australia's largest two-way services trading partner and the wider trading relationship between the two nations continues to experience growth.

A simple search of Dun & Bradstreet's Business Browser (which relies on publicly available information relating to public companies) can tell you that there are nearly 3000 US companies with an ultimate parent company in Australia. It is not unreasonable to expect that private companies add a multiple to that number.

Coupling this commercial context with the recognition that the US and Australia are two of the more advanced economies to have adopted the Model Law, there appears to be significant possibilities for cross-border insolvencies involving Australia and the US.

While the recent legislative reforms may have inched Australia closer to embracing a culture of corporate rescue, there remain critical challenges in achieving a Chapter 11 reorganisation through recognition of the Chapter 11 case in Australia as a main foreign proceeding.

Chapter 11 vs voluntary administration

A number of those challenges can be explained by the gaps between the debtor protections available through a Chapter 11 filing and the protections that a voluntary administration process affords Australian companies and directors.

The closest equivalent that Australia has to a Chapter 11 restructuring is administration, however it is a stretch to call the processes similar. Where a Chapter 11 is debtor-led, a voluntary administration, although often voluntarily involving existing management and equity holders, is creditor-led. An administrator is typically appointed to an Australian company if the company's board resolves that the company is or is likely to become insolvent. This type of appointment is commonly referred to as a 'voluntary administration' although the *Corporations Act 2001* (Cth) (the "*Corporations Act*") does not expressly use the term 'voluntary' other than in a passing definitional reference.

One similarity between a voluntary administration and with a Chapter 11 restructuring is that the voluntary administration applies a moratorium on creditors taking certain actions against the company during the period of the voluntary administration. But, that stay is at the same time narrower and wider than the automatic stay applying in a Chapter 11 case.

It is well known that upon a Chapter 11 filing an extensive automatic stay against claims enforcement applies to both secured and unsecured creditors and purports to have worldwide operation. The stay provides a period of time in which all judgments, collection activities, foreclosures, and repossessions of property are suspended and may not be pursued by the creditors on any debt or claim that arose before the filing of the bankruptcy petition.

The similarities between a voluntary administration moratorium and a Chapter 11 stay are that the moratorium in each process places a stay on:

- Taking steps to wind-up the company
- Some secured creditors enforcing their security interests
- Lessors or third parties (for example equipment lessors) on retaking possession of lease property or property owned by the third party
- Commencing or continuing court or enforcement proceedings against the company or its property

Where the Chapter 11 automatic stay and voluntary administration moratorium diverge is the treatment of directors and a specific class of secured creditors. The stays under a voluntary administration are narrower than the Chapter 11 stays in respect of secured creditor claims but are wider in the sense that directors are more protected. Secured creditors with security over the whole or substantially the whole of the assets of the company may take enforcement action if they do so within the 'decision period' (a period of 13 business days from the notice of appointment of the administrator) or with consent of the administrator or the Court. Under a voluntary administration the enforcement of personal guarantees provided by directors in respect of the obligations of the company is restricted. These two differences highlight the limitations in seeking recognition of a Chapter 11 case as the exclusive means of effecting a capital restructure of an Australian company with the US as the centre of its main interests.

The Model Law and the CBIA

Under Article 20 of the Model Law (which has the force of law in Australia), upon recognition of a foreign proceeding as a foreign main proceeding, a number of stays apply, including:

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

Where a Chapter 11 case is recognised as the foreign main proceeding in Australia, the Article 20 stays would, superficially at least, emulate the Chapter 11 automatic stay. But, the Article 20 stay remains subject to Australian laws relating insolvency moratoriums. Relevantly, under the Corporations Act the stays or suspensions are the same as would apply if the stays or suspensions arose under Chapter 5 (other than Parts 5.2 and 5.4A) of the Corporations Act. Chapter 5 of the Corporations Act gives secured creditors with security over the whole or substantially the whole of the assets of a debtor company the ability to enforce their security interests.

In this way, obtaining orders from an Australian court to recognise a Chapter 11 case in respect of an Australian debtor as the foreign main proceeding and the connected stays and suspension may still leave a gap for secured creditors to exploit to enforce their security interests. Secured creditors of Australian companies remain capable of exerting their own agency and can preserve the Australian ethos of creditor-led, rather than debtor-led, corporate restructuring. For an Australian debtor-led Chapter 11 filing, maintaining the effectiveness of the Chapter 11 stays could require separate lock-up arrangements with secured creditors.

This is especially significant where the Australian company is not included as a debtor in the Chapter 11 case.

Directors' risks and protections

Any time that an Australian company faces liquidity issues, Australian insolvency laws can create significant potential liabilities for directors. The Corporations Act contains a particularly severe regime for insolvent trading which is stricter than that of any other nation (with the possible exception of Germany). Directors can become personally liable for the debts incurred, including tax liabilities, by an Australian company that is insolvent. Although the recent reforms mentioned at the top of this article may have provided some comfort for directors to look to trade and preserve value through to a successful restructuring, those reforms were not intended to allow a company to trade beyond the point where it is no longer viable. The application of the Model Law through the CBIA in Australia does not alleviate this risk for a director of an Australian company before it enters administration, but once it is in voluntary administration the risk of liabilities for insolvent trading will cease.

Directors of Australian companies who have provided personal guarantees can also obtain the benefit of a stay on enforcement of those guarantees while the company is in voluntary administration. Such a stay would not apply where the sole basis for a stay is the recognition of a foreign proceeding, such as a Chapter 11 filing.

Directors of Australian companies will therefore continue to experience significant pressure to appoint administrators, even where a Chapter 11 case has been recognised as the main foreign proceeding.

Other limitations

Chapter 11 reorganisation plans will often propose a debt-for-equity swap as part of a capital restructure. An increasingly used mechanism in Australian voluntary administrations is for an administrator of a deed of company arrangement (the key restructuring agreement voted on by creditors during the voluntary administration – akin to a plan of reorganisation) to use section 444GA of the Corporations Act to seek leave of the Court to transfer the ownership of shares in the company.

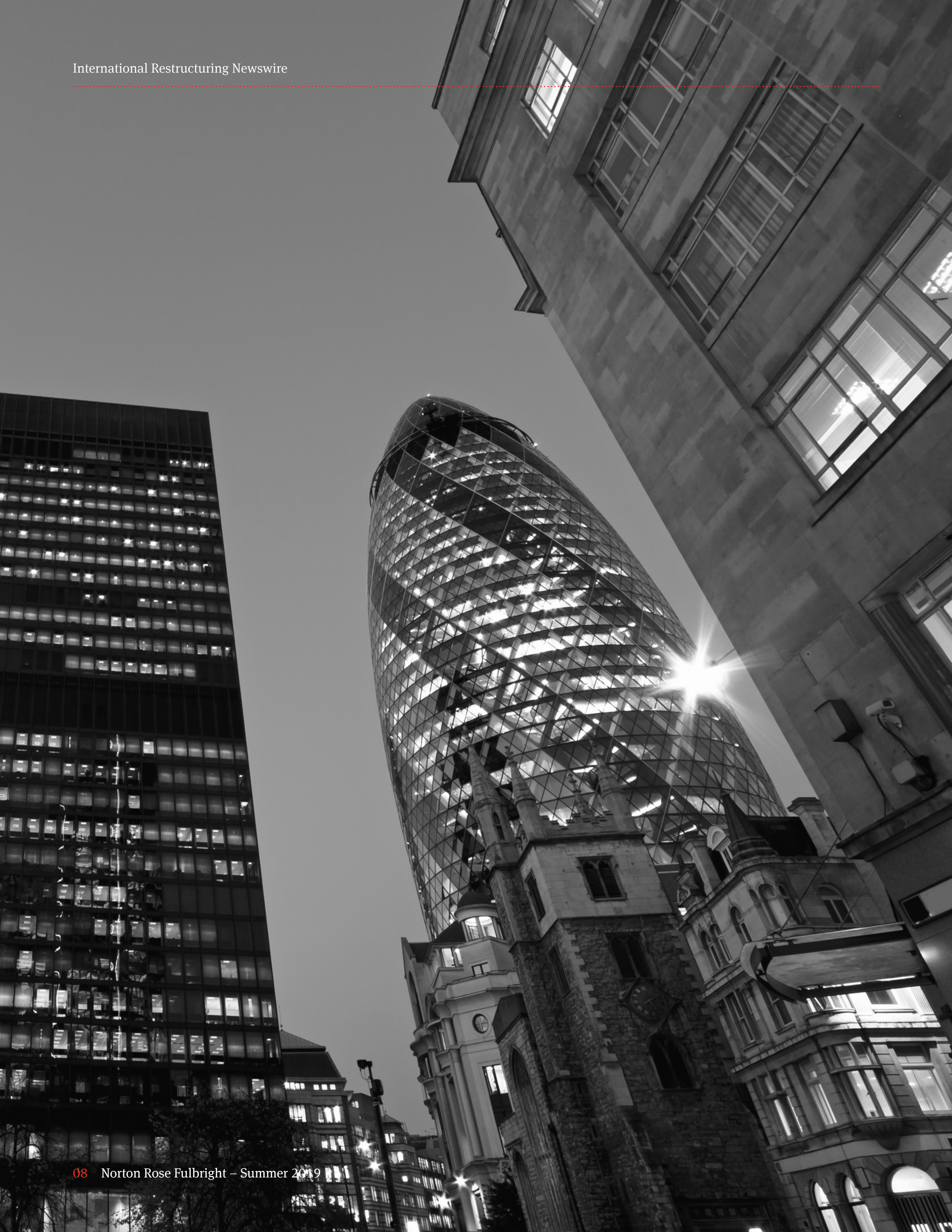
This power is now being used to effect debt-for-equity swaps and to cram down valueless equity interests.

This power is now being used to effect debt-for-equity swaps and to cram down valueless equity interests.

A limitation of a Chapter 11 reorganisation plan is that a debt-for-equity swap in respect of the Australian company could only be implemented by agreement of all stakeholders or by the application of a voluntary administrator to the Court.

As a result of the treatment of secured creditors and directors under the Australian voluntary administration process, effecting a Chapter 11 reorganisation solely through recognition of the Chapter 11 case in Australia as a foreign main proceeding is problematic. Debtors and creditors may need to look to use the voluntary administration process in conjunction with lock-up arrangements to ensure that directors of Australian companies obtain protection from personal liabilities, secured creditor rights are adequately suspended, and mechanisms to effect debt for equity swaps remain available.

Tim Mornane is a partner in our Sydney office and Jeffery Black is a partner in our Perth office, both are in the firm's global financial restructuring and insolvency group.



English Court of Appeal guidance on the claw back of dividends and directors' duties prior to insolvency: *BTI 2014 LLC v Sequana S.A.* [2019] EWCA Civ 112

Radford Goodman

Key points

The English Court of Appeal has confirmed that:

1. A company dividend is a *transaction for no consideration*. If the dividend was intended to put an asset beyond the reach of creditors (for example, as part of a scheme to ringfence a long-term liability) then there is a risk that it will be set aside by the court under section 423 of the Insolvency Act 1986, even if the dividend complied with the requirements of Part 23 of the Companies Act.

2. The common law duty on directors to take into account of the interests of creditors arises *before* actual insolvency, when the directors *know or should know that insolvency is likely*.

Therefore, when directors are considering paying a dividend, it is not sufficient to consider only whether there are distributable profits available for the purpose such that the proposed dividend complies with Part 23 of the Companies Act. The board should go on to consider if the dividend is being paid for proper purposes and, if the dividend would result in the company being, or likely to become, insolvent, the interests of creditors need to be considered.

Background

In the wake of the collapse of BHS and Carillion after having paid substantial dividends to shareholders, the reform of corporate dividends is the subject of an ongoing UK government consultation and is likely to remain high on the political agenda. In the meantime, the English courts continue to scrutinise dividends within the existing legal framework of company and insolvency law. In the recent case *BTI 2014 LLC v Sequana S.A* [2019] EWCA Civ 112, the Court of Appeal provided guidance on the potential for recovery of dividend payments under section 423 of the Insolvency Act 1986 (the "Act") ("*transactions defrauding creditors*") and the point in time at which a duty arises on directors to consider the interests of the company's creditors.

In summary, the case concerned dividends paid by Arjo Wiggins Appleton Limited ("AWA") to its parent company, Sequana S.A. ("Sequana"), in 2008 and 2009. At the time the dividends were paid, AWA was not trading. It had one (contingent) liability, which arose under an indemnity in respect of the potential clean-up costs and damages arising out of the pollution of the Lower Fox River in the US. In accordance with the relevant statutory requirements, the directors estimated the potential liabilities under the indemnity for the purposes of making provisions in Sequana's accounts. The High Court found that the provisions were properly made and the accounts were properly prepared. Its assets included certain insurance policies and a debt (€585m) owed by Sequana, its parent company. The dividends were paid by way of set-off against that intercompany debt, reducing the value of the debt to around €3m.

It was alleged by BTI 2014 LLC ("BTI") that the dividends were: (a) unlawful in that they failed to comply with Part 23 of the Companies Act 2006 (the "*could not pay*" claim), (b) paid in breach of the directors' duty to have regard to the interests of creditors (the "*should not pay*" claim) and (c) liable to be set aside under section 423 of the Act.

At first instance, the High Court dismissed all claims in respect of the 2008 dividend. In respect of the 2009 dividend, the court dismissed the *could not pay* and *should not pay* claims but gave judgment in favour of BTI in respect of the section 423 claim and, in

broad terms, ordered Sequana to repay to BTI, or meet in future (as the case may be), the environmental clean-up costs, up to the amount of the 2009 dividend (€135m).

Sequana appealed against the judgment under section 423 and BTI cross-appealed against the dismissal of the *should not pay* claim (but not the *could not pay* claim). The position on appeal, therefore, was that the dividend in question was accepted by all parties as having been compliant with Part 23 of the Companies Act 2006.

The section 423 claim

Section 423 of the Act provides a statutory cause of action where a person has entered into a transaction at an undervalue in order to try to put assets beyond the reach of creditors. The section provides that if a person enters into a transaction at an undervalue (which includes a gift) for the purpose of putting assets beyond the reach of a person who is making, or may at some time make, a claim against him or otherwise prejudicing the interests of such a person in relation to the claim which he is making or may make (the "*statutory purpose*") then the court can reverse the transaction and take such other measures to protect the interests of any victims as it deems fit.

Sequana's appeal rested on two submissions: first, that a dividend was not a "*transaction at an undervalue*" within section 423 and, secondly, that the requisite *statutory purpose* was not present.

Can a dividend be a "transaction at an undervalue"?

The Court answered this question in the affirmative.

First it held that a dividend is *not* a gift. David Richards LJ stated: "*Dividends are both commercially and legally a return on the investment. It would be startling to categorise dividends as gifts made by a company to its shareholders and there is no reason to think that parliament intended the word "gift" to carry anything other than its usual meaning.*"

But the Court held that a dividend *is* a transaction for *no consideration* and therefore qualifies as a "transaction at an undervalue" within section 423 without the need to undertake a valuation exercise. The fact that a dividend is paid in respect of rights conferred on the shareholders by the terms of issue of the shares or the terms of a company's articles, does not alone constitute sufficient or indeed any consideration. David Richards LJ held: "*In my judgment, it cannot be said that the company receives consideration for the payment of a dividend. It is not enough to say that the dividend is paid in accordance with the rights attached to the shares, where those rights are quite different from, for example, the right to receive interest payments on loan notes or the right to be considered for bonus declarations on a with-profits fund. If and when a company pays a dividend to* *shareholders, the terms of the dividend do not provide for the company to receive any consideration nor will it receive any consideration*."

As to the meaning of the word "transaction", the Court held that whilst a "transaction" will normally include mutual dealing, the wording of section 423 is such that it can also include unilateral acts, hence gifts are expressly within the scope of section 423. In any event, the court held that it would be wrong to regard a dividend as a wholly unilateral act since it is paid pursuant to, and in accordance with, the rights of shareholders.

The Court then turned to consider the *statutory purpose*. This is a question of fact. A court must look at the subjective intention of the person entering into the transaction – in this case AWA (or more precisely its directors). The *statutory purpose* need not be the sole purpose or even the dominant purpose: it is sufficient if it is *a* purpose (as opposed to a mere *consequence*). Furthermore, it is not necessary to show that the transaction was motivated by ill will towards a third party, nor is there any requirement to show dishonesty (despite section 423 having the word "fraud" in its title).

Having reviewed evidence presented at trial, the Court of Appeal upheld the High Court's finding that the purpose of the dividend was to put the debt due from Sequana to AWA out of the reach of the creditors of AWA in the event that AWA's insurance policies proved to be inadequate to pay AWA's liability for clean-up costs. David Richards LJ held that: "*The purpose was to eliminate the risk that Sequana would be responsible for AWA's liabilities if the [insurance policies] proved to be inadequate. That risk could be eliminated only if two steps were taken: elimination of the Sequana debt, thereby ending any legal obligation on the part of Sequana, and a disposal of AWA, thereby ending any moral obligation stemming from Sequana's policy of supporting its subsidiaries. The elimination of the Sequana debt removed the legal risk by removing the debt as an asset of AWA and so putting it beyond the reach of those who might make claims against AWA*."

The breach of duty claim

BTI appealed against the High Court's dismissal of its claim that the directors of AWA had breached their duty to AWA by authorising the 2009 dividend. BTI submitted that the directors of AWA owed a duty to consider the interests of creditors in any case where a proposal involved a real, as opposed to a remote, risk to creditors.

Having conducted a thorough review of the English and Commonwealth authorities, the Court of Appeal upheld the High Court's rejection of this submission and noted that, if correct, it would have a "*chilling effect on entrepreneurial activity*..." Nevertheless, the Court of Appeal held that the duty was not confined to situations where there was actual, established insolvency: it can arise at some point before that. David Richards LJ put it as follows: "*The precise moment at which a company becomes insolvent is often difficult to pinpoint. Insolvency may occur suddenly but equally the descent into insolvency may be more gradual. The qualified way in which judges have expressed the trigger...reflects that the directors may often not know, nor be expected to know, that the company is actually insolvent until some time after it has occurred. For this reason, among others, a test falling short of insolvency is justified*."

From the various formulations of the trigger point to be found in the authorities, the Court concluded that the duty arises "*when the directors know or should know that the company is or is likely to become insolvent*..." The court held that, in this context, "*likely*" means "*probable*".

The Court declined to express a view on the question of whether, from this point, the creditors interests should take priority over the interests of shareholders and other stakeholders as this question did not arise on the facts. Nevertheless, the Court expressed the view that "*where the directors know or ought to know that the company is presently and actually insolvent, it is hard to see that creditors' interests could be anything but paramount*."

Applying this test to the facts, the court held that at the time of the 2009 dividend the duty to consider the interests of creditors had *not* been triggered. The estimate of the contingent liability used for the accounts and for determining AWA's distributable profits had not been challenged by BTI and on that basis the contingent liability (with or without the dividend) could not be said to be likely to render AWA insolvent.

Please contact the author for more information, including citations.

Radford Goodman is a partner in our London office in the firm's global financial restructuring and insolvency group.

Quadriga bankruptcy: C$190 million may have turned into digital dust

Hugo Margoc

In 2018, Quadriga Fintech Solutions Corp. ("Quadriga"), through its wholly-owned subsidiaries, was one of Canada's largest online cryptocurrency exchanges. Quadriga survived the first boom and bust cycle of cryptocurrencies when the value of Bitcoin skyrocketed to C$25,000 and fell back down to C$4,200 all within one year, but it did not survive the death of its co-founder and CEO, Gerald Cotten.

After graduating from university in November 2013, Cotten, together with Michael Patryn, co-founded Quadriga, an online exchange that allowed users to store, buy and sell various cryptocurrencies, upon depositing cash or cryptocurrency with the exchange. Quadriga made money by charging its users a fee for each transaction on the platform. In 2014, only C$7.4m worth of bitcoin was traded on the exchange. In 2016, following the resignation of all other directors, Cotten became the sole director of Quadriga, which had no offices or employees, and engaged only a few general contractors.[1] The company was run from Cotten's encrypted laptop at his home in Fall River, Nova Scotia.

As the cryptocurrency markets soared in 2017, so did the trade volume on Quadriga with about C$1.2bn worth of bitcoin exchanged on the platform. While the spike in volume increased commissions, it also caused cash-flow problems due to the exchange's reliance on external payment processors as Quadriga did not have its own Canadian bank account that could handle these transactions. Increased trading volumes also exposed the weakness of Quadriga's accounting system. These were the primary causes of Quadriga's eventual downfall. In June 2017, Quadriga announced that they lost ethereum currency worth C$14m due to a smart contract error, which bridled the confidence of Quadriga's users in its ability to effectively manage the exchange.[2] Following the crash of the cryptomarkets, Quadriga customers reported delays when attempting to withdraw fiat currency from the exchange and critical payment processing issues emerged. The one-man operation of Quadriga had grown so quickly that it wasn't able to build out its infrastructure to service its growth.

On top of these payment processing and accounting concerns, on December 9, 2018, Cotten passed away at the young age of 30 during a trip to India. Cotten's death was publicly announced by Quadriga on January 14, 2019. Without Cotten to manage the exchange and without a centralized cash management system and due to frequent issues with withdrawal of funds and payment processing, the market panicked, losing confidence in the viability of the cryptocurrency exchange. Worse yet, Quadriga stored most of its cryptocurrency deposits in digital "cold wallets" on the hard-drive of Cotten's encrypted laptop, which were inaccessible after his death or, if accessible, contained minimal cryptocurrency units. The missing cryptocurrency was estimated to be worth C$190m at the time. In January 2019, C$25.7m in cash held by Custodian Inc., a Quadriga payment processor, was frozen by the Canadian Imperial Bank of Commerce, as the bank could not determine the ownership of the money and could not contact the exchange following Cotton's death. The money was later paid into court, which subsequently distributed the funds to Custodian; however, as a result of the temporary loss in liquidity in addition to the missing cryptocurrency, coupled with massive deposit withdrawal demands, Quadriga was unable to satisfy its obligations to its users. On January 28, 2019, the Quadriga website and exchange platform was shut down as a result of liquidity constraints. Quadriga has not carried on business as a cryptocurrency exchange since that date. As a result of the platform shut down, all of Quadriga's independent contractors, except for three individuals, were terminated effective February 28, 2019.

According to public filings, Quadriga had 363,000 registered users and owed in excess of C$260m in cash and cryptocurrency balances to 92,000 affected users.

On February 5, 2019 Quadriga and certain of its affiliates filed for creditor protection under the *Companies' Creditors Arrangement Act* (the "CCAA") to manage Quadriga's liquidity crisis. According to public filings, Quadriga had 363,000 registered users and owed in excess of C$260m in cash and cryptocurrency balances to 92,000 affected users. The claims ranged from very small amounts up to very large balances of up to C$70m.

Pursuant to an initial order, the Nova Scotia Supreme Court, amongst other things, issued a general stay of proceedings and appointed Ernst & Young Inc. as the monitor (the "Monitor") in the CCAA proceedings of Quadriga. Following the CCAA filing, the Monitor started investigating the assets and business of Quadriga and also tried to monetize the trading platform and recover the missing C$190m of cryptocurrency. The Monitor was able to recover all identified cash in the amount of C$25.2m held by various third-party payment processing companies, which were used by Quadriga to operate its business.

But, recovering the lost cryptocurrency was more complicated. To provide some technical background, cryptocurrency is generally stored in digital wallets. A wallet is a virtual address that stores a cryptocurrency trader's private and public keys, which allows the trader to send and receive cryptocurrency. There are so called "hot wallets", which are stored online, through a digital currency exchange, and "cold wallets", which are stored offline on a hard drive or a removable device such as an encrypted USB. While transactional activity and balances in any wallet are publicly available with a wallet address, the ability to transfer the cryptocurrency within the wallet is restricted to individuals holding the required passwords or credentials and, in the case of cold wallets, physical custody of the device that the private key of the wallet is stored on. When a user opened an account with Quadriga, as is customary with other cryptocurrency exchanges, the user was provided with a hot wallet address (the "User Wallet") to which the user could send cryptocurrency to be received by the exchange. The User Wallet address is typically (although not always) an address set up uniquely for a single user. The user's access only allows for transfers to that address. Following depositing cryptocurrency in the User Wallet, the user does not have direct control over the balance and the exchange has custody of the deposited cryptocurrency.

As is typical for cryptocurrency exchanges, upon receiving cryptocurrency in a User Wallet, Quadriga credited the user's exchange platform account with the corresponding quantity of cryptocurrency. Quadriga then controlled the cryptocurrency in the User Wallet, typically pooling the cryptocurrency deposited by users and moving the cryptocurrency to wallets, both hot and cold, under the exchange's control. Users with account balances can place orders for either other cryptocurrency or traditional currency. When a user ultimately wanted to make a withdrawal of cryptocurrency from its account with the exchange, the user provided instructions to Quadriga to send cryptocurrency to a specified wallet outside the exchange's control. Quadriga accessed its cryptocurrency pooled reserves to fulfill the transaction. Similarly, if a user wanted to withdraw fiat currency, the user would provide bank account or address information to the exchange.

During the course of the investigation, the Monitor was able to recover C$902,743 worth of cryptocurrency from Quadriga's hot wallets. According to public filings, Cotten generally transferred the pooled cryptocurrency deposits from the platform's hot wallets into cold wallets on devices in Cotton's control to protect the assets from possible hacking. Of course, after Cotten's death and without the appropriate passwords, Quadriga's cold wallets were inaccessible. To the extent that it was possible for the Monitor to gain access to Quadriga's cold wallets on Cotten's computer and USB drives, the Monitor found only nominal amounts of cryptocurrency in Quadriga's cold wallets. Without the wallet passwords that were only known by Cotten, the Monitor has been unable to gain access to Quadriga's full cryptocurrency inventory possibly stored on Quadriga's cold wallets.

The Monitor also became aware of occurrences where the corporate and personal boundaries between Quadriga and Cotten were not formally maintained, and it appeared to the Monitor that Quadriga funds may have been used to acquire assets held outside the corporate entity. The Monitor obtained an asset preservation order, which prohibited Cotten's wife, the Cotten estate, and other related entities from selling or otherwise disposing of their assets. The appraised value of the assets subject to the asset preservation order is C$12m, which could formally become part of Quadriga's estate on further order by the Court. As of April 12, 2019, Quadriga had C$28.6m of known assets and around C$216m owing to its creditors, out which C$214.6m was owed to 76,319 unsecured creditors represented by representative counsel.

In its fourth report to the Court, the Monitor concluded that the possibility that Quadriga would restructure and emerge from CCAA protection was remote. Subsequently, on April 11, 2019, the CCAA proceeding was terminated and the proceeding was converted into bankruptcy proceedings under the *Bankruptcy and Insolvency Act* (the "BIA"). The Monitor stated that as trustee under the BIA, it would have broader investigative powers to move along the investigation into Quadriga's missing assets and maximize value for Quadriga's creditors. The Monitor, now acting as trustee in Quadriga's bankruptcy proceeding, is still looking to sell Quadriga's trading platform.

According to a statement on the website of the United States Federal Bureau of Investigation (the "FBI") on June 3, 2019, the FBI, the Internal Revenue Service Criminal Investigation division, the US Attorney's Office for the District of Columbia and the Department of Justice's Computer Crime and Intellectual Property Section are conducting an investigation into the missing assets of Quadriga.

The Quadriga case has many of the same complications as past cryptocurrency insolvencies in other jurisdictions relating to proper characterization and valuation of creditor claims, division of distributable assets among claim holders, and dissipation of assets. However, the Quadriga case also adds a layer of complexity that arises when no party remains available to unlock potentially very significant asset value. This will be a significant issue for future cases to ensure that all potential asset value can be preserved and distributed to creditors and other claim holders.

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[1] Co-Founder, Michael Patryn left Quadriga in 2016 following a dispute with Cotten.

[2] A software upgrade performed by the company had an error in the code that prevented the smart contract from properly processing incoming amounts of the cryptocurrency Ether. The error was not caught for a few days, and during that time, Ether sent to the company's exchange was "trapped" in the smart contract.

Supply chain finance: Financial restructuring implications

Joe McHale

Introduction

Whilst no two financial restructurings are the same, a common key driver in any distressed scenario is the ongoing liquidity of the company. How a company manages liquidity is important for its stakeholders and is fundamental to understanding any potential restructuring options.

Some companies use supply chain finance arrangements as part of their cash flow management processes. Those arrangements are structured and operate in a very different way to traditional debt and bond financings.

It is important to understand the key characteristics of any existing supply chain finance arrangements and to ensure they are properly considered in any wider restructuring as well as to consider whether implementing a supply chain financing programme may form part of any turnaround strategy.

Basic Overview

"Supply chain finance" is used in different contexts and has different meanings in different financing markets. For the purposes of this article, when we refer to "supply chain finance" we also refer to "reverse factoring."

A basic supply chain finance may be structured on the following general lines (although there are numerous variations):

- A company and a counterparty supplier enter into a contract pursuant to which the supplier provides goods or services to the company and invoices the company on delivery or performance.
- Subject to the terms of the supply chain finance programme, a financier may purchase any "eligible" invoices from the supplier for the value of the invoice minus an agreed discount. This in turn enables the supplier to offer longer payment terms to the company whilst receiving prompt payment of the relevant amount from the financier.
- The financier now owns the invoice and (at least under English law), provided notice of the assignment has been given to the company, the company is legally obliged to settle the invoice with the financier on its due date.
- The company settles the invoice with the financier in due course in accordance with the invoice terms (or in accordance with the terms of the supply chain finance arrangements to the extent the company may have entered into any direct obligations with the financier).

From the company's perspective they receive the goods or services and are able to manage payments on the basis of the extended timeline. This can aid a company's liquidity management, allowing it to better manage specific payments.

From a financier's perspective they are able to benefit from a margin (i.e. the discount) based on the price they paid for invoice from the supplier versus the monies they receive from the company in settlement of the invoice.

From the supplier's perspective they receive payment (at a discount to reflect the time value of the early payment) from a creditworthy source, and earlier than they would have done compared to dealing solely with the company – this may be beneficial for its own cash flow purposes.

Key features of supply chain financing

Supply chain finance programmes are typically tailored and will be structured in different ways depending on the nature of the underlying transaction or the requirements of the relevant counterparties.

Key characteristics may include:

"Off balance sheet" treatment

A number of supply chain finance structures are purposefully designed to constitute "off balance sheet" transactions from a "borrowings" perspective. They typically constitute a sale of the relevant receivable rather than the incurrence of financial indebtedness. From the company's perspective there is no balance sheet effect in most cases since all that happens is the payee has changed (although this may not be the case where the company additionally undertakes direct obligations in favour of the financier).

It is beyond the scope of this article to consider the nuances of off balance sheet treatment, but it is important to appreciate this as part of any due diligence exercise of a distressed company's balance sheet.

Security

Such structures are usually not subject to security arrangements (although market practice differs across jurisdictions). The transactions are typically characterised as the purchase and sale of receivables. In the event of non-payment, the financier will have a claim against the company under the terms of the invoice it has purchased from the supplier.

In addition, the company may be prohibited from providing security in support of supply chain financing arrangements under the terms of a negative pledge contained in any other finance facilities.

Non-recourse

Such arrangements are typically non-recourse in respect of the supplier – meaning in the event the company is unable to settle the invoice the financier has no recourse against the supplier, only the company.

Guarantee support

Some structures are supported by a corporate guarantee. In the event of non-payment by the company, the financier is able to demand payment from the third party (typically the parent or an affiliate of the company) who has guaranteed the company's liabilities.

In certain scenarios, the need for supply chain finance to improve the liquidity practices of a company may present an opportunity for existing lenders

As with every guarantee, its strength is predicated on the underlying financial strength of the third party. Consideration as to: (i) the financial strength of a guarantor; and (ii) the potential scope and number of competing claims on an insolvency of the guarantor should be part of any credit analysis.

Legal due diligence

It is necessary to understand the relevant governing law of the invoice (this will usually match the underlying sale contract). Further consideration as to any relevant terms and conditions to which the invoice may be subject should also be a consideration from the financier's perspective (which could include for example, prohibitions on assignment, rights to set-off payments, etc.). Both points are particularly pertinent in any scenario where a financier is purchasing a large number of invoices.

Carillion

In the United Kingdom, supply chain finance has received increased press coverage in the last 18 months – predominantly due to the collapse of Carillion (being the largest construction corporate insolvency in British history).

It has been reported that at the point of Carillion's liquidation, the company had access to £500m of supply chain finance from suppliers and had drawings of around £350m under those finance programmes.

After Carillion entered liquidation, a UK parliamentary report examined the collapse of the company. The report is wide-reaching in its content and it commented upon Carillion's supply chain financing arrangements, specifically focusing on two elements:

- Carillion's arrangements with its suppliers (including the length of payment terms)
- The impact of those arrangements from an accounting perspective

Senior lenders considerations

It remains challenging for a company with a large supply chain and which contracts with a large number of trade creditors, to effectively manage its liquidity and cash flow projections.

Senior lenders need to strike a balance between understanding the full picture of a borrower's liabilities (not just the debt reported on its balance sheet) and allowing the directors of the company sufficient scope and flexibility to run the company as they see fit.

With supply chain finance arrangements in mind, senior lenders may wish to consider including relevant information reporting undertakings and to ensure that a company's supply chain finance arrangements are within the scope of a reporting accountant's work.

It is important for senior lenders to have visibility of the situation as well as an understanding of how their position in an insolvency of the company would be affected by supply chain finance.

In certain scenarios, the need for supply chain finance to improve the liquidity practices of a company may present an opportunity for existing lenders – if they have the ability to offer the financing themselves. However, it should be recognised that even if such a facility is uncommitted, a decision by the financier providing the supply chain finance to not make such financing available in a distressed scenario could result in a liquidity crisis for the company.

Conclusion

Supply chain financing is a widely used tool – especially in sectors where companies are dealing with a large number of counterparties. Prudent and effective management of a company's liquidity is important at all times but especially in circumstances of a financial restructuring.

In the context of a restructuring, stakeholders should be mindful of the scope and impact of any existing supply chain finance arrangements.

Notwithstanding certain high profile cases, effective supply chain finance can provide opportunities to improve the financial performance of a company and better manage relationship with key counterparties. As with any restructuring process, the suitability of any supply chain financing is subject to the underlying nature of the business, the sector it operates in and relevant market practices.

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The Canadian Tobacco Litigation: Imperial Tobacco, Rothmans, Benson & Hedges and JTI-Macdonald under creditor protection

Hugo Margoc

A recent decision of the Quebec Court of Appeal in class-actions lawsuit against Canada's major tobacco distributors has forced each of the major players in the Canadian tobacco industry to seek creditor protection under the *Companies' Creditors Arrangement Act* (the "CCAA").

Imperial Tobacco, Rothmans, Benson & Hedges and JTI-Macdonald (the "Tobacco Distributors") are the three largest tobacco distributors in Canada offering a range of tobacco-based products under multiple trademarks. They make up the majority of legal Canadian tobacco industry sales. Each of these distributors is indirectly owned by a large, international parent corporation.

All ten provincial governments have filed "Medicaid" lawsuits against the Tobacco Distributors and their parents, jointly and severally, asserting claims in excess of C$500bn, plus interest and costs. There are also many ongoing class action lawsuits against the Tobacco Distributors, advanced on behalf of various subgroups of Canadians over the years, most of which allege joint and several liability. While tobacco-related lawsuits have been ongoing across the country, a major blow to the Tobacco Distributors was recently delivered by the Quebec Court of Appeal.

In 1998, two class action lawsuits were filed against the Tobacco Distributors in the Quebec Superior Court seeking over C$20bn in compensatory and punitive damages to 100,000 Quebec victims, of lung and throat cancer and emphysema caused by consumption of cigarettes between 1950 and 1998. On February 21, 2005, both cases were granted certification. The trial was concluded in 2014 and, on May 27, 2015, Judge Brian Riordan of the Quebec Superior Court ordered the Tobacco Distributors to pay C$15.6bn in moral and punitive damages. The Tobacco Distributors appealed the Judgment to the Quebec Court of Appeal. On March 1, 2019, the Quebec Court of Appeal upheld the trial judgment, with minor modifications, in a unanimous decision.

Following the decision by the Quebec Court of Appeal, the total individual liability for Imperial Tobacco, Rothmans, Benson & Hedges, and JTI-MacDonald stand at C$9.15bn, C$2.71bn, and C$2bn respectively, with interest and additional indemnity for moral damages and punitive damages. However, the exposure of each Tobacco Distributor can be up to the value of the judgement due to joint and several liability in the event the other Tobacco Distributors are unable to satisfy their allocated portion of the damages. The total liability owing under the judgement exceeds each of the Tobacco Distributors' assets by billions, though each of the Tobacco Distributors have healthy operating businesses.

On March 8, 12 and 22, 2019, JTI-Macdonald, Imperial Tobacco and Rothmans, Benson & Hedges were respectively granted protection under the CCAA by initial orders issued by Ontario Superior Court of Justice, among other things, issuing a general stay of proceedings, which not only suspended any monies payable by the Tobacco Distributors to class-action plaintiffs following the Quebec Court of Appeal decision, but also suspended all other lawsuits against the Tobacco Distributors.

As part of the CCAA proceedings, the Ontario Superior Court of Justice appointed a claimant coordinator to coordinate the complex tobacco-related claims and serve as liaison between all of the parties involved across the three CCAA proceedings. The claimant coordinator's role was later extended to act as the Court-appointed mediator in the proceedings.

The CCAA process could result in a comprehensive resolution between the Tobacco Distributors and not only the Quebec class-action plaintiffs but also the plaintiffs in the provincial and other lawsuits against the Tobacco Distributors. Precedent for a settlement of similar lawsuits can be found in the United States. In the 1990s, Philip Morris USA and its rivals entered a settlement that forced them to make annual payments to 46 states in perpetuity, including US$206bn over the first 25 years. In the alternative, the Ontario Superior Court of Justice could lift the stay of proceedings to allow the Tobacco Distributors to appeal the judgement by the Quebec Court of Appeal before the Supreme Court of Canada to give the Tobacco Distributors a final chance for rebuttal. According to a spokesperson for Imperial Tobacco Canada, the company intends to challenge the judgement.

The legal challenges have so far had little impact on the market capitalization of the publicly listed parent companies. According to analysts, the impact on value has been muted because the cases are likely to drag on for some time. In addition, the Tobacco Distributors only generate a small percentage of the earnings for any of their parent companies. In contrast to the Quebec class actions, the "Medicaid" lawsuits by the ten provincial governments against the Tobacco Distributors pose a bigger threat by naming parent companies as co-defendants, though progress in the provincial litigation has been slow. For example, British Columbia filed its claim 18 years ago. Insolvency practitioners in Canada will likely be following and dealing with the tobacco litigation for years to come, unless the proceedings of the Tobacco Distributors under the CCAA lead to a comprehensive resolution.

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In the 1990s, Philip Morris USA and its rivals entered a settlement that forced them to make annual payments to 46 states in perpetuity, including US$206bn over the first 25 years.

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