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Suggested Clarifications And Reforms For U.S. Chapter 15 And The UNCITRAL Model Law On Cross-Border Insolvency On Which It Is Based: The Pragmatic Cynics' Concerns[1]

> "New U.S. Chapter 15 is like a nuclear enrichment facility, which can be either (1) a helpful tool for constructing improved economic results on a global basis, or (2) a weapon for causing greater foreign main proceeding recoveries from U.S. assets and subsidiaries at the expense of U.S. creditors. The focus should not be just on the qualities of the tool/weapon, but also on who uses the device and for what purpose."
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> [Cross-border insolvency attorney advocating defensive involuntary U.S. bankruptcies before Chapter 15 filings in order to reduce the adverse impacts of Chapter 15 on U.S. creditors.]
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> "You don't have to outrun the bear, only the guy next to you."
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> [Old U.S. saying, applied by one cross-border bankruptcy attorney to a threatened strategic foreign main proceeding designed by the foreign parent to solve liability problems for its foreign managers with the turnover of U.S. assets and U.S. subsidiaries to the foreign main proceeding.]

1 Most of the discussion on the UNCITRAL Model Law on Cross-Border Insolvency, largely followed in the new Chapter 15 of the U.S. Bankruptcy Code, has been idealistic praise by "universalists" with a vision of a better world and an end to what they often call the "territorial" "grab rule." As a pragmatist and a U.S.-based insolvency lawyer involved in cross-border insolvency cases for more than three decades, I advocate attention now to the cynics, who generally have little interest in long-term debate and theories, but instead have a keen interest in practical results for creditors predictable during the long transition to that better world. Among other reasons for that short-term focus is a concern that what happens now in transition will change what could otherwise happen later. If the results of Chapter 15 prove excessively harmful to the U.S. creditors on whose patience this law ultimately depends, the reforms and clarifications suggested here may help moderate the reactionary changes which are otherwise foreseeable.

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A. A Bold Experiment with Far-Reaching Effects

New Chapter 15 of the U.S. Bankruptcy Code[2] is a bold experiment in well-intentioned internationalism (what scholars often call "universalism"), designed, in theory, by its advocates to promote global cooperation and to facilitate economically beneficial reorganizations of global enterprises. Indeed, few other examples come to mind of the U.S. adopting wholesale a U.N. model law, such as the UNCITRAL Model Law on Cross-Border Insolvency (the "U.N. Model Law"). Similarly, there are few counterparts in U.S. law to the new uniform international interpretation rule of § 1508, which requires U.S. courts to consider deferring to foreign court precedents, such as the London cases that interpret sections of the European Community Insolvency Regulation (the "EIR") that are similar to U.S. law with respect to the vague concept of the "center of main interests" determining the forum for the foreign "main proceeding" ("COMI").[3]

However, if the future results of this experiment are disproportionately to reduce U.S. creditors' recoveries, as critics expect, the foreseeable reactions of U.S. creditors may cause advocates of the U.N. Model Law and its Chapter 15 counterpart to wish that they had been less bold. The risk of U.S. creditor lobbies demanding subsequent U.S. legislation to reinstitute or even increase protections for U.S. creditors is the least of the problems. What will often be more disturbing to advocates of the U.N. Model Law embodied in Chapter 15 are the foreseeable U.S. creditor defensive strategies that will evolve as such creditors begin to realize their exposures. For example, the future will eventually become a race between U.S. creditors filing involuntary U.S. bankruptcy cases and the foreign representative filing Chapter 15 and seeking to prevent those involuntary cases. This obstruction to consensual cross-border restructurings will not please the advocates of Chapter 15 "universalism." More importantly, there could often be greater than necessary litigation expense and discord at a level that will disturb those seeking global cooperation and cost-effective reorganization.

It is a tribute to the potential reach and power of Chapter 15 that the advocates of strengthening the power of "master netting agreement" remedies for certain U.S. financial contracts (*e.g.*, swaps, repo's, forward contracts, commodity contracts and securities contracts) perceived the need to insulate those reforms from the impact of Chapter 15. *See* Bankruptcy Code § 561(d). Those sophisticated creditors took no chances of the kind confronted by the rest of the U.S. creditors, whose lobbyists failed to perceive or address those same risks inspiring other lobbyists to demand the § 561(d) override of Chapter 15.

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[2] References to statutory sections in this Outline are to sections of Chapter 15 of Title 11 of the United States Code (the "Bankruptcy Code"), unless otherwise specified.

[3] Council Reg. 1346/2000, 2000 O.J. (L160) 1, *et seq.*

On the other hand, and to show the nonpartisan nature of the Chapter 15 debate, some U.S.-based private equity and hedge funds investing in distressed debt assets are exploring the purchase of selected foreign distressed debt claims in certain foreign main proceedings. These U.S. investors perceive an opportunity for greater recovery on certain priority categories of foreign distressed debt (especially on a longer list of foreign priority or statutory lien claims) by using Chapter 15 to shift U.S. assets and U.S. subsidiaries to the foreign main proceeding. The many other tactics available generally for increasing certain priority foreign debt recoveries at the expense of U.S. creditors are tempting to sophisticated players seeking the "next new thing" before it becomes too popular with their less adventurous peers.

This commentary focuses upon certain problems inherent in Chapter 15 to which "U.S. creditors" will predictably react as and when they suffer what they consider to be unacceptably greater losses than would have occurred prior to Chapter 15. (As used herein, "U.S. creditors" refers not only to creditors who reside in the U.S., but also to foreign persons who traditionally buy U.S. debt and participate in U.S. bankruptcy cases.[4]) That reaction can be especially strong when the U.S. losses arise (1) from the redistribution of assets of U.S. subsidiaries in favor of higher priority claims in the forum chosen for the parent's foreign main proceeding, or even (2) from the material U.S. operations of a foreign debtor in a foreign main proceeding. The U.S. objections begin, for example, with the concern that when U.S. assets on which U.S. creditors relied are transferred to the foreign main proceeding, the U.S. creditors will suffer more than simple dilution by pooling global assets with equal priority creditors throughout the world. A U.S. concern is that, for instance, the disproportionately larger and more senior, administrative and priority claims and foreign statutory or other liens in the foreign main proceeding will strip U.S. creditors of the recovery that they consider to be fair and reasonable from U.S. assets moved to the foreign main proceeding. That concern becomes especially serious when the foreign administrative and priority claims or statutory or other liens in the foreign main proceeding deprive U.S. secured creditors of their expected recovery and rights to their U.S. collateral.

Such clarifications and reforms should not become caught in the theoretical debates between "modified universalism" (or the more idealistic, unqualified UN "universalism") versus "cooperative territorialism" (or the more extreme "local grab rule").[5] Rather, the debate should

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[4] With few exceptions not material for this purpose, the Bankruptcy Code does not treat foreign creditors worse than U.S. creditors in U.S. bankruptcy cases. Therefore, many foreign-based creditors participate regularly in U.S. bankruptcy cases, either directly or through funds. When the Chapter 15 results begin to disappoint their recovery expectations, foreign players may pull out of some sectors and reduce the liquidity enjoyed by the distressed debt markets.

[5] This discussion is NOT about the academic merits of Chapter 15, or the other variations of the UNCITRAL Model Law, or related idealism or cynicism regarding the rule of law of relevant countries in multinational insolvency cases or evolution some day to a better world. Most academics and some optimistic (or, some say, opportunistic) practitioners praise Chapter 15 by citing its aspirations for increased global cooperation, theoretically leading (in an ideal world) to better results for everyone dealing with global businesses. However, some cynics generally believe that the proponents of the U.N. Model Law and Chapter 15 both (i) undervalue the importance of predictability of recovery for U.S. creditors in achieving global harmony, and (ii) under appreciate how many insolvency experts are now intending to exploit the system for the benefit of their clients

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focus on the "real world" practical test: When does the risk of loss by U.S. creditors under Chapter 15 become too serious, causing them to be willing peremptorily to use the "nuclear option" of filing involuntary U.S. bankruptcy cases in order to frustrate the feared foreign main proceeding and Chapter 15 filing? Applying that test is not hard in practice. All one has to do is ask the "club" of sophisticated U.S. bankruptcy counsel at what point they will advise their clients to implement that defense. Some are advising involuntaries already, in part inspired by the threatened maneuvers some U.S. debtor attorneys are using in restructuring negotiations, often supported by allied foreign insolvency lawyers and credible forum shopping structural changes in their clients (*e.g.*, the creation of intermediate holding companies in places desired for their foreign main proceedings). Proponents of Chapter 15 and the U.N. Model Law will find less tolerance than they appear to expect, once negative experiences cumulate in the future. Another corollary way of phrasing the same principle is to ask this question of those same U.S. bankruptcy lawyers: When will sophisticated U.S. bankruptcy counsel advise their hedge fund and other foreign distressed debt buying clients to buy selected priority claims in the foreign main proceeding in order to take advantage of Chapter 15 shifting value from the U.S. creditors to the priority claims in such foreign main proceeding?

This article refers to the "foreign main proceeding" only in an effort to illustrate some reasons for reform without making the discussion even more complex or lengthy. However, there are issues as well with "foreign non-main proceedings." That is especially true in situations where the foreign main proceeding debtor accommodates favored local interests in selected other countries with concessions to the foreign non-main proceeding. This will most commonly occur where the debtor desires to protect management in that other foreign forum.

B. Unilateral Disarmament?

When evaluating the suggestions in this Commentary, Chapter 15 proponents should ask themselves a further question: Based on the effect of the requirements in Chapter 15 for the U.S. courts and trustees unilaterally and proactively to assist and to cooperate in many ways with the foreign main proceeding and its foreign court and the foreign representative, what reciprocal cooperation and assistance can the U.S. courts, trustees and creditors reasonably expect in return? One cynic described Chapter 15 as the equivalent of "unilateral disarmament" of U.S. creditors in a world often hostile to their recovery from U.S. assets and subsidiaries. Having unilaterally already given away significant leverage generously in Chapter 15, what can U.S. creditors expect in return from the foreign representative and foreign main proceeding court? By contrast, cross-border insolvencies historically were based upon a multi-national judicial treaty (protocol) negotiated between insolvency cases on the basis of comparative balance of power and value in each case *e.g., Maxwell* and *Federal Mogul*). By unconditionally giving away U.S. creditors' leverage in Chapter 15 without U.S. creditors receiving assurance of anything in

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seeking advantage in a "zero sum" game in cross-border recovery competition. Worse, because U.S. bankruptcy practice has evolved in what debtor lawyers and some judges have described as a "scream or die" dynamic, there predictably will be more "screaming" than many foreign main proceedings are used to hearing.

return, Chapter 15 weakens their bargaining power, forcing them to create alternative leverage (*e.g.*, the involuntary bankruptcy option) before the Chapter 15 filing.

Among the many examples of unilateral accommodations by U.S. creditors to the foreign representative in Chapter 15, without required reciprocity from the foreign main proceeding for any reciprocal benefit or condition, consider these benefits for the foreign main proceeding:

- Although the foreign representative automatically becomes a power player in any Chapter 15 or other bankruptcy case in the U.S. (§ 1512), that foreign representative does not subject himself to U.S. jurisdiction when he files his Chapter 15 petition.[6] *See* § 1510.

- The foreign representative can file a voluntary or involuntary U.S. bankruptcy case (§ 1511),[7] although that would normally be done to collect preferences or fraudulent transfers under the Bankruptcy Code from U.S. defendants in order to raise proceeds for the benefit of the foreign main proceeding;

- The foreign representative is entitled to direct access to the U.S. courts for many purposes beyond Chapter 15 (§ 1509), with a wide variety of assured (i) "cooperation" and direct communication (§§ 1509, 1525, 1526, 1527), (ii) "assistance" (§ 1507), (iii) rights to notice and extra time to respond (§ 1514), conferring the ability thereby often to achieve a foreign main proceeding ruling first before the U.S. court can rule on the key issue, (iv) ability to file avoiding power/turn over and similar claims in a pending or foreign representative filed Chapter 7 or 11 case (§ 1523(a)), (v) ability to intervene in any State or Federal Court case in which the debtor is a party (§ 1524), and (vi) other accommodations in coordinating the various proceedings (§§ 1529, 1530). For example, consider some of the many Chapter 15 unilateral benefits for the foreign representative:

    - § 1525(a): "the [U.S.] court shall cooperate to the maximum extent possible with a foreign court or a foreign representative";

    - § 1526(a): "the [U.S.] trustee or other person, including an examiner . . . shall, subject to the supervision of the [U.S.] court, cooperate to the maximum extent possible with a foreign court or a foreign representative";

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6 Local U.S. participation occurs without normal accountability for the foreign representative. Although the foreign representative receives the benefit of commencing a Chapter 15 case, the foreign representative does not thereby subject itself to the jurisdiction of any court of the U.S. for any other purpose. § 1510. U.S. creditors committees or other representatives have no such reciprocal protections when they participate in the foreign main proceeding (sometimes a dangerous tactic).

7 Once the Chapter 15 is "recognized," the foreign representative can file a Chapter 11 or 7 for a debtor with U.S. assets. Then, Chapter 15 adds procedures for cooperation and coordination of simultaneous proceedings to prevent inconsistent rulings and results. *See* §§ 1525-1532. As noted herein, U.S. creditors may be better protected, if the U.S. bankruptcy predates the Chapter 15. *See* § 1529(1).

- Other expanded cooperation and communication under §§ 1525-1527;

- § 1528: the foreign representative can file a U.S. Chapter 11 or 7 case against the debtor as to U.S. assets, so as to collect U.S. assets from U.S. defendants for later turnover to the foreign main proceeding (as in *In re Axona Int'l Credit & Commerce Ltd.,* 88 B.R. 597 (Bankr. S.D.N.Y. 1988));

- § 1529: the U.S. court must coordinate and cooperate with the foreign court and foreign representative in many ways, especially when the Chapter 15 *precedes* the U.S. bankruptcy;

- § 1532: in order to "true up" U.S. creditors with foreign creditors recovering offshore, the foreign creditors' U.S. bankruptcy distributions are treated like U.S. distributions, so there is no double recovery. (Problems abound in classification comparisons, because foreign creditors' recovering on priority claims under foreign law deny that such claims are in the same "class" as U.S. unsecured creditors.); and

- Chapter 15 (§ 1514) assures the foreign representatives and foreign creditors of notice (and certain § 1515(d) translations), at U.S. creditor expense, creating extra time for creditors with foreign addresses to respond to U.S. court motions under § 1514(d). There is no requirement for any reciprocal notice or translation accommodations for U.S. creditors in the foreign proceeding. *But see* § 1518, related to unbalanced, limited information from the foreign representative. This means that there is a risk that the foreign representative can delay U.S. rulings on key issues until after the foreign representative first obtains the ruling on the same issue that is desired in the foreign main proceeding. U.S. creditors can be prejudiced in such a race to decision by such pre-emptive foreign main proceedings rulings, especially in some places in the world where there is alleged to be less U.S.-style due process or reliable justice.

The customary discretionary factors under former § 304 still generally apply to certain "additional assistance" requested from the U.S. court by the foreign representative in the foreign main proceeding under § 1507. However, that foreign representative is now automatically entitled under § 1520 to each of the following relief under Chapter 11, subject to the overall U.S. "public policy" exceptions in § 1506:

- an automatic stay as to the debtor and debtor's property within U.S. territorial jurisdictions;

- the right to operate the debtor's business;

- the right to sell and deal with property in the same manner as a trustee or debtor in possession in the U.S.; and

- (under § 1511(a)) the foreign representative from the foreign main proceeding may commence a voluntary or involuntary U.S. bankruptcy case for a debtor with U.S. assets (§ 1528)

One other anxiety inspiring such defensive planning by such concerned U.S. creditors is their intuitive rejection of the premise of the U.N. Model Law that every country in the world merits comity (and more) for its foreign main proceeding. Such U.S. creditors worry that they will be denied, in practice, even minimal U.S. style due process and fair treatment by certain foreign main proceeding courts, whether because of local laws and practices or on account of corruption, political bias or other inappropriate factors in certain forums.[8] Because the U.S. Foreign Corrupt Practices Act prohibits U.S. creditors from competing with those who might corrupt or improperly influence the foreign court, such U.S. creditors fear they will be at an impossible disadvantage in certain foreign courts, with few safeguards or protections under Chapter 15. The prior practice under § 304 and in cross-border insolvency cases involved sufficient reserved discretion by U.S. courts in order to enable U.S. creditors to have the leverage to negotiate bilateral recovery deals with the foreign main proceeding. *See, In re Maxwell Commc'n Corp.*, 170 B.R. 800 (Bankr. S.D.N.Y. 1994) (negotiated joint U.S. Chapter 11 plan of reorganization and U.K. scheme of administration), and, more recently, *In re Federal-Mogul Global, Inc.*, 282 B.R. 301 (Bankr. Del. 2002) (combined its U.S. Chapter 11 plan of reorganization with UK company voluntary arrangements for numerous affiliated units, among other things addressing massive asbestos claims).

Moreover, attempting to prove that a foreign main proceeding court is actually corrupt or wrong is often going to be very difficult or practically impossible in that court or even in a U.S. Chapter 15 bankruptcy court. Nevertheless, there are precedents and advisory service studies which identify some countries as straying too far from an acceptable rule of law as to entitle them to bind U.S. interests in U.S. courts. *See, e.g., In re Hourani*, 180 B.R. 58, 66-69 (Bankr. S.D.N.Y. 1995) (the court, applying former § 304(c)(2) to protect U.S. creditors, refused to turn U.S. assets over to a Jordanian liquidator, because Jordan's process ignored preferences and fraudulent transfers and fundamental creditor protections, including the right to notice); *see also* "Global Corruption Report 2005: Special Focus – Corruption in Construction and Post-conflict Reconstruction," Transparency International (2005). If and when Chapter 15 courts grant rights to foreign representatives from countries where <u>non</u>bankruptcy judgments are <u>not</u> binding in the U.S., U.S. creditors will regard that inconsistency as at least puzzling. *See* discussion below about the U.S. Uniform Foreign Money Judgment Recognition Act.

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[8] Generalizations asserted here, as well as exceptions not discussed, require adjustments on a country-by-country basis, especially in nations where justice is perceived to be less reliable than in the U.S. *See*, for example, the global corruption indexes used to illustrate certain preconceptions of certain players about countries of perceived concern or opportunity, depending on who is playing the game. For example, on one useful corruption index, Japan was the 24th-ranked country from the top of the list of 145 levels of corruption (level 1 being least corrupt), well ahead of Italy (42), Brazil (59), Mexico (64), China (at 71, tied with Saudi Arabia and Syria), India (at 90, tied with Russia), Argentina (at 108, tied with Libya and Palestine), and Indonesia (133). Transparency International, *Global Corruption Report 2005* at 235-238 (2005). By comparison, the U.S. is at level 17, behind many familiar countries in Scandinavia and Western Europe, as well as Canada, Hong Kong and New Zealand. *Id.*

C. <u>Pricing Variables Under New Chapter 15</u>

Calculating viable recoveries under new Chapter 15 is complex, especially where there is an opportunity to dodge inter-company claims of U.S. affiliates and even U.S. preference and fraudulent transfer laws as to foreign affiliates, such as by what substitutes for substantive consolidation in the foreign main proceeding and other disallowance of claims from the U.S. *See also* the controversial decision in *In re Maxwell Commc'n Corp.*, 170 B.R. 800 (Bankr. S.D.N.Y. 1994), *aff'd* 186 B.R. 807 (S.D.N.Y. 1995), rejecting extraterritoriality for § 547 preference claims against foreign defendants to protect the foreign main proceeding for comity and other reasons. *But see* 28 U.S.C. § 1334(e) and *c.f. Celotex Corp. v. Edwards*, 514 U.S. 300 (1995). Furthermore, inter-creditor and inter-debtor disputes become far more complex when cross-border, for better or for worse.

At the core of the cynics' view of the new Chapter 15 variables in pricing distressed debt is an evaluation of the following factors, among many others:

(a) Chapter 15 weakens U.S. creditor protections and defenses against a foreign main proceeding that is designed in a foreign forum friendly to the transfer of value from the U.S. to the foreign main proceeding, especially in countries where the rule of law is less reliable or is more accommodating to local preferred interests, or where foreign priority or administrative claims and statutory liens generally will dominate and leave less net shares for U.S. creditors. Critics predict especially lower recoveries than expected by U.S. creditors on debts owing by U.S. subsidiaries of foreign debtor parents, or from U.S. assets of foreign debtors in a foreign main proceeding, where the foreign representative uses its Chapter 15 leverage aggressively. That seems especially likely in countries where there is less U.S.-style justice under a reliable rule of law or where there are more extreme priority claims and statutory liens to be paid ahead of U.S. creditors. Some decisions found that former § 304(c) required substantial accord with the Bankruptcy Code, among other things, to prevent prejudice from problematic foreign priority rules that unfairly prejudice U.S. creditors. *See In re Treco*, 240 F.3d 148 (2nd Cir. 2001). Others were more generous to the foreign representative from a respected jurisdiction, but were more careful in countries with less reliable rules of law. Some academics and idealistic practitioners expect Chapter 15 to make few practical differences compared to prior practice. However, cynical insolvency professionals and some experienced creditors believe that results will depend on factors such as the quality of justice in the foreign main proceedings, which, in turn, depends upon the substantive and procedural law of that foreign proceeding, including whether it has adopted the UNCITRAL Model.

(b) Chapter 15 is based on a U.N. political model that makes (what some critics describe as) idealistic and academic (some also say noncommercial) assumptions about the conduct of certain controversial players, judges, governments and countries in dealing with cross-border issues.[9] By adopting the UNCITRAL Model law in Chapter 15, the U.S. for the first time accepts what cynics call the U.N. "political fiction" as a "legal fiction" (*i.e.*, that all countries have viable rules of law compatible with fair treatment of creditor rights everywhere). Protection of U.S. creditors now depends under Chapter 15 on (i) a one-sentence, narrowly to-be-interpreted safeguard in § 1506 against actions "manifestly contrary to the public policy" of the U.S., and (ii) the "sufficient protections" for U.S. creditors test in §§ 1521(b) and 1522(a) (which cynics fear will become as weak and unhelpful as such critics complain that the § 361 "adequate protection" standard has become in practice under the Bankruptcy Code, especially in courts popular with forum-shoppers). Some cynics fear other players' forum-shopping success in the quest for the "Foreign Delaware Extreme" by use of strategic intermediate, foreign holding company debtors designed for that purpose.

(c) Chapter 15 makes unilateral concessions and accommodations on behalf of U.S. creditors and assets in favor of a foreign main proceeding anywhere in the world, without either (i) requiring reciprocity or assurances of fair balance (from the perspective of U.S. creditors), or (ii) preserving important, traditional leverage in the U.S. to compel the negotiations of reciprocity or fairness (from the perspective of U.S. creditors), such as was previously accomplished in cross-border protocol deals negotiated from positions of a reciprocal balance of power. Critics perceive Chapter 15 as, in effect, "unilateral legal disarmament" of U.S. creditors in a world often unfriendly to U.S. creditor expectations about recovery from U.S. assets and U.S. subsidiaries. Instead of relying on the traditional, reciprocal "balance of power" to inspire bilateral and multilateral deals, Chapter 15 unconditionally makes certain unilateral concessions and accommodations to the foreign main proceeding anywhere in the world, without requiring any reciprocity. *See* Section I.B. above.

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[9] Prior § 304(c) allowed flexibility to the U.S. courts to protect U.S. creditors in various dangerous situations, not expressly recognized now by Chapter 15. The U.N. Model does not include, for all purposes, some of the former § 304(c) factors designed to prevent unfair results in foreign proceedings that do not provide U.S.-style justice or due process. While former § 304 recognized that some foreign proceedings may involve corruption, political influence or cultural imperatives (protection of local insiders or governmental officials, regardless of their culpability), the U.N. Model used in Chapter 15 seems largely to ignore those factors, except where they create "public policy" objections under § 1506. Like the notoriously flawed and idealistic California energy deregulation plan successfully exploited by Enron and others who played to "game the system," Chapter 15 creates increased opportunities to disappoint even the idealists' expectations in the "real world." It seems inevitable that some will also "game the system" in foreign main proceedings.

(d) Chapter 15 requires more accommodations and concessions from the U.S. bankruptcy process in favor of the foreign main proceeding than does the "comity" standard under former § 304 or the enforcement of foreign judgments laws. The comity test previously required the court to use its discretion to determine whether the law of the foreign jurisdiction incorporated "fundamental standards of procedural fairness" and was not contrary to U.S. legal policies. Comity then was a consideration, but not an obligation. By contrast, Chapter 15 imposes cooperation and deference by the U.S. bankruptcy court, unless there is (a) a violation of U.S. public policy contrary to § 1506, or (b) less than "sufficient protection" for creditors contrary to §§ 1521 and 1522, or (c) a Chapter 11 or 7 case to coordinate under § 1529.

In any event, this commentary suggests several modest reforms and clarifications that could help U.S. creditors find greater tolerance with Chapter 15. In particular, just as the Commission on Uniform State Laws created "Official Comments" to the Uniform Commercial Code in order to guide the courts and creditors (among others), expert groups like the International Insolvency Institute should be encouraged to publish comments for such guidance.

II. PREDICTIONS TO ILLUSTRATE EFFECTS OF U.S. CHAPTER 15 AFTER EXPERIENCE CONVINCES THE PLAYERS THAT THEY ARE NOW IN A NEW GAME:

A. Some Recovery Questions

Consider the following key practical questions about recovery variables:

1. Does Chapter 15 increase the risk of lower recovery by U.S. creditors from U.S. assets and U.S. subsidiaries compared to former § 304 practice, especially where the foreign main proceedings are in countries where critics perceive there to be less U.S.-style justice and unfavorable laws (*e.g.*, huge priority and administrative claims of many kinds and priming statutory liens)?[10] [YES.]

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[10] Foreign main proceedings may apply foreign laws that create priorities for creditor classes and claim amounts that often would result in lower recoveries for U.S. secured and unsecured creditors compared with any comparable U.S. bankruptcy, even if limited to U.S. located assets. For example:

(1) foreign governmental and tax claims often have priority and are large (and sometimes exaggerated);

(2) foreign laws may create large, priority or administrative claims for employees, retirees and other favored classes of local creditors;

(3) many foreign countries allow what would in the U.S. be "statutory liens" avoidable under 11 U.S.C. § 545;

(4) some foreign countries' priority, administrative, statutory and other lien claims often even are senior to consensual liens;

(5) in practice, foreign insolvency proceedings may be less effective or aggressive in recovering from insiders on preferences, fraudulent transfers and other avoiding power claims; and

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2. Stated another way, does Chapter 15 increase the opportunities for buyers of selected foreign distressed debt (*e.g.*, expanded priority claims and statutory liens) to increase their recovery in a foreign main proceeding from U.S. assets and affiliates, at the expense of U.S. creditors? [YES.]

3. Is there reasonable cause for concern/hope that a U.S. Chapter 15 court may turn U.S. assets over to a foreign main proceeding, even when the foreseeable result will be lower U.S. creditor recoveries, for example, on account of significant foreign priority and administrative claims and statutory liens? [YES.]

4. Are U.S. creditors at risk of having their public policy defenses under § 1506 and their "sufficient protection" rights under §§ 1521(b) and 1522(a), becoming impotent through forum shopping and foreign, universalist precedents required to be followed in the U.S. under § 1508, or otherwise? [YES.]

5. Can U.S. creditors decrease risks of loss and increase recoveries by racing to file a U.S. involuntary bankruptcy case ahead of Chapter 15 or the foreign main proceeding? [YES.]

Critics fear that Chapter 15 generally may reduce U.S. creditors' recoveries from U.S. assets and from U.S. subsidiaries in "foreign main proceedings." For example, concerns include the following results, for which certain clarifications and reforms are suggested in Section V, *infra*. U.S. assets are vulnerable to being turned over to the foreign main proceeding where, among other things, large foreign priority and administrative claims and non-avoidable foreign statutory liens will often depress net distributions for both U.S. <u>secured</u> and <u>unsecured</u> creditors.[11] *See, e.g.*, §§ 1521(b), 1522.

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(6) certain U.S. secured creditors (especially judgment lien holders) can be stripped of those liens in foreign proceedings, even though having valid liens on U.S. assets. Even the minority of former § 304 cases protecting U.S. creditors may no longer protect them now under Chapter 15. *See, e.g.*, *In re Treco*, 240 F.3d 148 (2nd Cir. 2001) (no turnover to Bahamian liquidators under former § 304, where that foreign law's administrative claims would be senior to the U.S. bank secured creditor, stripping the collateral in effect); *In re Toga Mfg., Ltd.*, 28 B.R. 165 (Bankr. E.D. Mich. 1983) (denying § 304 turnover to strip a lien in Canada).

[11] Special attention should be given to the potential interaction of Chapter 15 with the Draft Enterprise Bankruptcy Law of the People's Republic of China. China's Article 127 provides substantial priorities over unsecured claims, including at the highest priority a concept of "joint interest debts" (Article 40) that, besides post-petition acceptance of labor and social insurance premiums and other familiar administrative claims, includes any debt incurred from personal injury caused by the debtor's properties. Product liability and environmental claims familiar to U.S. creditors will create substantial risk in China for other kinds of creditors. In addition, the second priority below those claims is granted for pre-petition wages and social insurance premiums for workers and nonmanager staff, but those claims are <u>also</u> payable from China's Article 113 property, in effect, priming <u>secured</u> creditors as well as unsecured creditors.

B. Limited Protection for U.S. Creditors

Chapter 15 offers weak protections for U.S. creditors that critics fear too often may be impaired or evaded by the foreign representative. For example, the primary U.S. protections are only:

(a) where the Chapter 15 action "would be manifestly contrary to the public policy" of the U.S., as narrowly applied under § 1506;

(b) that the U.S. court must be "satisfied that the interests of creditors in the United States are sufficiently protected" when U.S. assets are turned over to the foreign representative for distribution in the foreign main proceeding under § 1521(b);

(c) applying only the "sufficient protection" test under § 1522(a), the U.S. court may grant, modify or terminate other relief for the foreign representative under §§ 1519 or 1521—including potentially granting much of a foreign representative's wish list, except, for example, the right to commence U.S. avoiding power claims (*e.g.*, preference or fraudulent transfer claims) in a Chapter 15. However, the foreign representative (§ 1523(a)) could commence a U.S. Chapter 11 or 7 (or participate in a case commenced by others), so as to accomplish such claim recoveries in order to later attempt to turn over the proceeds to the foreign main proceeding;

(d) the EU insolvency experience shows that the "public policy" protection for local creditors in § 1506 is not always likely to be meaningful protection against the increased economic losses as a consequence of the shift of the foreign main proceeding for a subsidiary to a forum chosen by the parent corporation. *See, e.g.*, *Re SAS Rover France* [2005] EWHC 874 (Ch) (unrep), Tribunal de Commerce de Nanterre (France) 19 May 2005 (unrep) (insolvent UK parent arranged *ex parte* simultaneous filing for UK administration of a subsidiary French company on account of UK parent management allegations under Recital 13, ignoring the apparent economic center of main interests in France, based on the location of assets, employees, creditors and other factors, including the Article 3 presumption created by the registered office in France). Experience thus far demonstrates that each forum wants to declare itself to be the main foreign proceeding in an often ex parte race to the first decision. The recent European Court of Justice decision in *Parmalat*, discussed below, may reduce, but does not eliminate this concern.

C. Comity

Because Chapter 15 is based upon the U.N. Model Law and because § 1508 requires U.S. courts to interpret that law consistently with the "application of similar statutes adopted by foreign jurisdictions" and considering the law's "international origin," U.S. creditors can be vulnerable to more severe results than would be predicted from the context of U.S. bankruptcy law. For example, while U.S. law has previously recognized that sufficient U.S.-style due process and justice are not reliably available in certain countries, whether because of politics, fear of powerful locals, corruption or other factors, the U.N. Model Law interpretations, often to be followed in Chapter 15, diplomatically apply the "political fiction" that any and all countries have acceptable rules of law administered on the merits by honest and capable judges. (Putting an unreliable or objectionable foreign insolvency proceeding on trial in a U.S. bankruptcy court is a difficult undertaking, and often becomes infeasible, especially if qualified witnesses are intimidated or if certain relevant foreign precedents are followed in the U.S., such as those requiring proof of actual fraud or malfeasance in the individual foreign main proceeding itself.) *See*, with respect to the Uniform Foreign Money-Judgments Recognition Act: *Bridgeway Corp. v. Citibank*, 201 F.3d 134 (2nd Cir. 2000) (rejecting a Liberian court judgment); *Bank Melli Iran v. Pahlavi*, 58 F.3d 1406 (9th Cir. 1995) (rejecting an Iranian court judgment); Jay M. Zitter, Construction and Application of Uniform Foreign Money-Judgments Recognition Act, 88 A.L.R. 5th 545 (2001); Sheldon R. Shapiro, Vaild Judgment of Court of Foreign Country as Entitled to Extraterritorial Effect in Federal District Court, 13 A.L.R. Fed. 208 (2005); Invalidity of Judgment of Court of Foreign Country, 9 AMJUR ROF 3d 687. The U.S. Supreme Court recently decided to exclude firearm convictions entered in foreign courts [there Japan] for purposes of a U.S. felon in possession of firearms laws, in part because: "They would include a conviction from a legal system that is inconsistent with an American understanding of fairness." *See Small v. United States*, 544 U.S. 385, 125 S.Ct. 1752 (2005).

To what extent does Chapter 15 now require a change in the general rule that foreign states and their citizens are not entitled to access to federal courts, where the U.S. does not recognize relations with such foreign state? 28 U.S.C. § 1332(a) and common law comity allow access to sue U.S. citizens in federal courts only to recognized foreign states and their nationals, but generally not to unrecognized governments, which are not such "foreign states." *See, e.g., Klausner v. Levy*, 83 F. Supp. 599 (E.D. Vir. 1949); *Guaranty Trust Co. of New York v. United States*, 304 U.S. 126 (1938); *Pfizer Inc. v. Gov't of India*, 434 U.S. 308 (1978). Chapter 15 critics cite to the U.S. public policy exception in § 1506 as incorporating such existing principles, despite contrary foreign § 1508 interpretations.

Most of the commentary so far on Chapter 15 is idealistic and, apart from those countries with U.S.-style rules of law, sometimes at variance with U.S. commercial experience. That academic perspective is shown, for example, in its criticism of certain former § 304 precedents that refused to turn over U.S. collateral of U.S. creditors to foreign main proceedings, where the consequence would have been to strip off the value of the U.S. lien by diluting it with senior foreign priority or administrative claims and with senior foreign statutory liens. Certain U.S. secured creditors (especially judgment lien holders) can be stripped of those liens in foreign proceedings, even though having valid U.S. liens on U.S. assets. Even the minority of former § 304 cases protecting U.S. creditors may no longer protect them now under Chapter 15. *See, e.g., In re Treco*, 240 F.3d 148 (2nd Cir. 2001) (no turnover to Bahamanian liquidators under former § 304, where that foreign law's administrative claims would be senior to the U.S. secured creditor, and, in effect, strip the secured creditor's lien); *In re Toga Mfg., Ltd.*, 28 B.R. 165 (Bankr. E.D. Mich. 1983) (denying § 304 turnover to strip U.S. lien in Canadian proceeding).

Chapter 15 interpretation principles (§ 1508) seem to direct the focus externally to harmonize with foreign court interpretations of the U.N. Model, and Chapter 15 (§ 1508) requires uniform interpretation with other jurisdictions adopting some part of the U.N. Model since 1997, such as:

(a) parts of the EIR; and

(b) Japan, Mexico, Poland, BVI, South Africa, Eritrea, Montenegro, British Virgin Islands and, most recently, England, Wales and Scotland.[12]

Such § 1508 precedents may be applied to frustrate U.S. creditors of debtors with U.S. businesses or assets, especially with respect to:

(a) the narrow scope of U.S. public policy limitations for theoretically protecting U.S. creditors under § 1506;[13] and

(b) consolidation of external and U.S. subsidiaries into the foreign main proceeding of the parent debtor, in forum shopping practice in the future often a litigation crafted intermediate holding company.

Apart from the "public policy" (§ 1506) or "sufficient protection" test (§§ 1521 and 1522) limitation, there is no apparent, meaningful U.S. screening in Chapter 15 for:

(a) what are generally perceived by U.S. creditors as commercially problematic foreign countries, whether because of politics, corruption, incompetence, secrecy, hostile laws, local favoritism, statutory liens, or priorities, or other local laws frustrating U.S. creditors' reasonable expectations;

(b) problematic foreign procedures or processes in such forums; or

(c) other practical frustrations of U.S. creditor expectations, including personal dangers to persons in or submitting to such foreign jurisdictions.

The U.S. Foreign Corrupt Practices Act, 15 U.S.C. § 78m, *et seq*., illustrates a problem in various countries with respect to corruption. Because U.S. creditors are not allowed to compete with foreign interests in seeking advantageous rulings in corrupt jurisdictions, results in those

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12 *See* the UNCITRAL website and the Status List at www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html.

13 There are also U.S. sources that creditors will seek to use for guidance, especially with respect to the U.S. public policy concerns under § 1506. Critics fear a lower standard for "recognition" of the foreign proceeding under § 1515 than for prior relief under former § 304, or otherwise. While there is a public policy exception under §§ 1506/1517, it is narrowly interpreted and limited to "the most fundamental policies of the United States." H.R. Rep. No. 109-31(I) at 109 (2005).

jurisdictions may disappoint U.S. creditors. *See, e.g.*, Transparency International, *Global Corruption Report 2005*, including the popular Corruption Perception Index at 233-38.

D. Key Practical Questions About U.S. Defensive Tactics to Dodge Chapter 15 Risks

Are there defensive strategies to Chapter 15 risks for U.S. creditors that can affect the calculation of distressed debt recoveries, even in a situation where those influencing or controlling the foreign main proceeding decide to maneuver aggressively to maximize their positions in that case at the expense of U.S. creditors? [YES.] For example, will there eventually be more and sooner U.S. involuntary bankruptcies by U.S. creditors seeking to protect themselves from increased losses when the U.S. Chapter 15 court grants certain relief to the foreign representative, including the turnover of U.S. assets to the foreign main proceeding? [YES.]

U.S. creditors will eventually learn that, in practice, their primary protection against Chapter 15 risks is to commence involuntary U.S. Chapter 11 or 7 cases before the Chapter 15 is filed. *Compare, e.g.*, § 1529 (1) vs. (2) (reducing, but not eliminating, the exposure of U.S. creditors to the foreign representative, if the U.S. bankruptcy is "pending" when the Chapter 15 is filed). However, even in that situation, Chapter 15 still exists and empowers a new player in the U.S. bankruptcy case, who often will have different goals than the U.S. creditors.

In many Chapter 15 situations (as prior to Chapter 15) the common result may still be a negotiated cross-border protocol deal among the U.S. and foreign proceedings. But note that Chapter 15 makes many unilateral concessions to the foreign representative and confers benefits on the foreign representative unconditionally, as discussed in Section I.B. above, thus weakening the leverage of the U.S. creditors in such negotiations.

To prevent the dilution or loss of Chapter 15 leverage by the foreign representative for the foreign main proceeding when an involuntary U.S. bankruptcy case is filed under Chapter 11 or 7, foreign representatives who win the race to file Chapter 15 first may seek in Chapter 15 "first day orders" to enjoin U.S. involuntary bankruptcy case filings by U.S. creditors under § 105. *See* § 1521(a)(7) (allowing the foreign representative to do in Chapter 15 anything a U.S. bankruptcy trustee could do in a U.S. case, except commence avoidance actions under §§ 522, 544, 545, 547, 548, 550 and 724(a), setup by 1519(a)(3) and 1520(a)(1)). *But see* § 1528, discussed below. Moreover, if the U.S. creditors wish to keep their choice of U.S. forum, they must file their involuntary bankruptcy petitions prior to the Chapter 15 filing. Otherwise, the foreign representative's choice of forum in the earlier Chapter 15 filing may enable the foreign representative to seek to transfer any involuntary case in another forum to the foreign representative's forum under U.S. Bankruptcy Rules 1014(b) and 1015.

E. Venue and Other Jurisdiction-Related Concerns, And Involuntary U.S. Bankruptcies

The transfer-of-venue cases discussed above have important strategic consequences. For example, foreign representatives generally prefer to forum shop in the Southern District of New York, among other things, because of both (i) long precedential tradition of comity, "universalism," and often rejecting many so-called "territorial" arguments, and (ii) its controversial decisions protecting the foreign main proceeding from U.S. creditors, such as

Maxwell, 170 B.R. 800 (preventing collection of § 547 preferences from foreign creditors in U.S. Chapter 11, and among other reasons, abstaining to protect the foreign main proceeding in the UK for comity, *forum non conveniens*, and implied limits on extraterritoriality).

Chapter 15 cases are to be filed either where the debtor has its principal place of business in the U.S., or where its principal U.S. assets are located in the United States. *See* 28 U.S.C. § 1410. This means fewer Delaware filings. There is no express opportunity for a non-New York based debtor to file in New York simply because it has a U.S. affiliate filing there. *But see* the transfer of venue rules, discussed herein. *See* U.S. Federal Rules of Bankruptcy Procedure, Rules 1014(b) and 1015. This may mean inconsistent U.S. Chapter 15 results from separate U.S. filings in different places by foreign representatives for separate U.S. debtors. Bankruptcy precedent in New York and Delaware may be less influential in U.S. bankruptcy courts elsewhere, despite § 1508's appeal for uniform interpretations.

Another reason for U.S. creditors filing an involuntary U.S. bankruptcy first is that court relief granted in a prior Chapter 15 may not be possible to correct in a subsequent U.S. bankruptcy. For example, the foreign representative may argue that appeals of many Chapter 15 decisions (*e.g.*, the transfer or distribution of U.S. funds for the foreign main proceeding) may be "moot" and, therefore, never heard on their merits.

If U.S. creditors do not beat the Chapter 15 filing with an involuntary bankruptcy filing to reduce the Chapter 15 impacts (*e.g.*, § 1529(1)), the U.S. creditors can still overcome some parts of Chapter 15 by a <u>subsequent</u> bankruptcy filing (*e.g.*, § 1529(2) requiring relief under § 1519 or 1521 to be "modified or terminated if inconsistent with the [Chapter 11 or 7] case" in the U.S.). However, if the automatic stay triggered by recognition is not sufficient under § 1520(a)(1), the foreign representative can be expected to seek a § 105 injunction against U.S. creditors filing any involuntary bankruptcy from the Chapter 15 court under §§ 1519(a)(3) and 1521(a)(7) so as to avoid that override of Chapter 15. *But see* § 1528 (stating that a U.S. bankruptcy for a debtor which has U.S. assets "may be commenced," but does not say by whom, or if this overrides a § 105 injunction).

Because of the dramatic consequences of losing the race to the strategic court (*e.g.*, for U.S. creditors the risk of grossly reduced recoveries on <u>secured</u> and <u>unsecured</u> claims, if U.S. recovery sources are transferred to foreign main proceedings, especially in countries with large, local priority and statutory lien claims), future cross-border workouts can more quickly crash into insolvency or bankruptcy proceedings. Indeed, because of director and officer liability exposure in many foreign countries, using U.S. assets to pay foreign employees, taxes and other local creditors is a big incentive for aggressive use of Chapter 15 tactics.[14]

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[14] The pressures on management in some countries is illustrated by the exposures of each managing director of German companies, if he or she fails timely to file a petition to open an insolvency proceeding for the insolvent company. Besides a criminal offense punishable by jail (up to three years) and large fines (up to 1.8 million Euros), such managing directors are liable for damages analogous to the U.S. concept of "deepening insolvency" for what German law tests as "illiquidity" or "over indebtedness." Apparently, even a U.S. Chapter 11 filing may not satisfy that German law.

Of course, U.S. involuntary bankruptcy law itself will present challenges for these strategies. For a recent discussion of the filing of an involuntary bankruptcy petition under Bankruptcy Code § 303, *see In re Globo Comunicacoes e Participacoes S.A.*, 317 B.R. 235 (Bankr. S.D.N.Y 2004) (Globopar is a Brazilian TV production company whose headquarters, employees and principal assets were located in Brazil, where it was engaging in an "out-of-court restructuring." However, it had borrowed from U.S. creditors and accessed U.S. capital markets, some of whom were unhappy with that restructuring and focused on U.S. assets (*i.e.*, a bank account and equity in a Delaware subsidiary), where those U.S. transactions could create in personam and in rem jurisdiction over the foreign debtor and its bankruptcy estate). *See* 11 U.S.C. §§ 303, 541 and 28 U.S.C. §§ 157 and 1334. *But see In re Bd. of Directors of Multicanal S.A.* 314 B.R. 486 (Bankr. S.D.N.Y. 2004) (where a noteholder of an Argentine company, with no U.S. assets besides several small bank accounts, sued in N.Y. to evade the acverdo prentivo extrajudicial [APE] restructuring in Argentina, and, when Multicanal filed a § 304 ancillary proceeding, the noteholder attempted an involuntary bankruptcy, which the bankruptcy court rejected in favor of the § 304 relief supporting the APE)[15]. Because certain foreign main proceeding debtors can be expected to transfer cash and liquid assets upstream out of the U.S. before their strategic insolvency filings, the best means of keeping the maximum benefits of that "grab" may be for the foreign representative to prevent a U.S. Chapter 11 or 7 case by using Chapter 15 pre-emptive tactics.

F. Tactics for Manipulating the Center of Main Interests ("COMI") Test to Confirm the Foreign Main Proceeding

Chapter 15 defers in many important ways to the "foreign main proceeding," which under § 1502(4) means a foreign insolvency proceeding pending in "the country where the debtor has the center of its main interests," a vague concept that excites the appetites of some forum-shoppers. The theory of the U.N. Model Law is addressed to a debtor-by-debtor individually without express arrangements for subsidiaries to be either administratively or substantively consolidated with their ultimate or intermediate parents in the same foreign main proceeding.[16] Moreover, where confronting a multinational group, the "center of main interests" depends on the level in the group at which the insolvency is focused. This is where "forum shopping" occurs, and where the debtor can manipulate the choice of forum by where it creates the strategic intermediate holding companies for the main foreign proceeding.

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15 There is more to the *Multicanal* story. Besides conventional priority disappointments where foreign priority laws deprive U.S. creditors of their higher U.S. recovery result, foreign laws can allow discrimination among creditor classes created at the same priority level. *See, e.g. In re Board of Directors of Multicanal S.A.*, 340 B.R. 154 (Bankr. S.D.N.Y. 2006), a decision on remand from the S.D.N.Y. at 331 B.R. 537 (S.D.N.Y. 2005), addressing 307 B.R. 384 and 314 B.R. 486 (Bankr. S.D.N.Y. 2004) (and ancillary proceeding under former § 304 involving discrimination against retail bondholders in an Argentina acuerdo preventivo extrajudicial ["APE'] exchange). While it appears that the small U.S. bondholders were ultimately able to improve their position under former § 304, they probably would have been less successful in a Chapter 15 case filed today.

16 However, forum-shoppers advocate that the center of main interest of a subsidiary can be engineered to be the center of main interest of its intermediate parent, through the exercise of sufficient control. While *Parmalat* articulates a rule that helps rebut that position, the decision has not discouraged forum-shoppers, although they now are making their supervision and control more "objective and ascertained by third parties."

While some critics charge that London is attempting to become the "Delaware" or "New York" equivalent of the EU for insolvency cases, other foreign countries can also be expected to compete aggressively for foreign main proceedings by offering the kind of "results" desired by those who have the choice where to file the main proceeding. Forum shopping can be achieved by the use of intermediate holding companies in the favored site with the appearance of enough administrative control to satisfy the emerging "London" test of the "center of main interests" for the foreign main proceeding venue for both the intermediate holding company and its subsidiaries, even as moderated in the recent decision of the European Court of Justice ("ECJ") in Eurofood IFSC Limited, the Irish finance subsidiary of *Parmalat* SpA (herein called the "*Parmalat*" case), discussed below. Because of the emerging EIR model of the race in an *ex parte* or uncontested first day hearing often to be the first court to declare itself the foreign main proceeding, some critics charge that the "center of main interests" or "Comi" test could mean nothing more than having won the race to the first foreign court that wants the main proceeding, despite the *Parmalat* ruling. (While in *Parmalat* the ECJ reaffirmed the original intent of the EIR to prevent this kind of race to be the first court to declare itself as the foreign "main proceeding," many forum shoppers do not read the ECJ as having "closed the door" to their maneuvers.). For example, critics fear that U.S. bankruptcy courts applying §§ 1502(4) and 1516 may follow the EIR as to what is a "main" or "non-main" proceeding, based on the EU test as to the "center of main interests" ("COMI") or "establishment." *See* § 1508 requiring U.S. courts to consider the international character of the law and to apply a uniform interpretation consistent with "similar statutes adopted by foreign jurisdictions."

The most recent pronouncement of the ECJ on the EIR (EC Reg. No. 1346/2000) addressed in its *Parmalat* decision the attempt by both the Irish and Italian Courts to proclaim themselves the "main proceeding" for Eurofood IFSC Ltd. in Case No. C-341/04 decided May 2, 2006 (Westlaw No. 604J0341). While various interpretations have been offered, the net result on the issues relevant here seems to be as follows:

1. The first member state court to open a main proceeding in accordance with its national process is the main proceeding to which the other Member States must defer, unless they have an EIR Article 26 objection that such recognition would be manifestly contrary to that State's public policy and, in particular, "its fundamental principles on the constitutional rights and liberties of the individual." Thus, creditors in the correct but unrecognized COMI State could ask that State to refuse to recognize the first declared "main proceeding" in another State where there is a "flagrant breach of the fundamental right to be heard." In practice, this may mean that the current EU ex parte practices may need to be modified somewhat to fend off challenges by providing minimum procedural due process to objectors. One would expect, however, that the improved due process would normally not change the result when the forum shopper has done a careful job on engineering the kind of COMI facts persuasive to that main proceeding judge. In other words, apart from improved process with less surprise, *Parmalat* skill leaves the first filed main proceeding to decide COMI and its jurisdiction on its own standards.

2. In order to rebut the EIR Article 3(1) presumption that the debtor's registered office is its COMI, the main proceeding court must find to the contrary based upon "factors which are both objective and ascertainable by third parties." A "mail drop" registered office is not the COMI. On the other hand, "the mere fact that its economic choices are or can be controlled by a parent company in another member State is not enough to rebut the presumption

laid down by the Regulation." However, in between is where the forum shoppers must engineer their COMI case, and address the concern of the 13th recital of the Regulation about "where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." In practice, forum shoppers believe that they need only make the intermediate parent's "administration," supervision and control more "objective and ascertainable by third parties" in order to empower the selected forum to decide that it is the main proceeding.

Since the *Parmalat* decision, the French Tribunal de Commerce de Nanterre opened insolvency proceedings (No. PCL 2006J00174 (2/15/06) involving redressement judiciarie, like English administration) in relation to the EMTEC Group, including companies registered in France, Italy, Belgium, Poland, Austria, Spain, the Netherlands and Germany. In ruling after adversary proceedings against the challenge regarding the German operating subsidiary with substantial German employees, assets and creditors, Judge Eric Herve Bazin held France to be the COMI based upon publicly ascertainable "head office functions" in France, as well as objective control by French managing directors and the utility of consolidated French main proceedings as facilitating a global plan of restructuring for their unified European distribution network.

Among the objective and ascertainable administration by French affiliates of the German debtor were responsibility for business strategies, financing, liquidity, and other financial management as well as concluding supply agreements and distribution of goods. From the perspective of forum shoppers, these kinds of arrangements are comparatively easy to structure into an intermediate holding company in the jurisdiction selected for the main proceeding.

Thus, forum-shoppers expect that, with improved due process and greater care about the EMTEC factors being ascertainable and objective, the "London trend" will continue under the EIR to allow parent company administrative control to establish the "center of main interests" for consolidating the foreign main proceeding for material subsidiaries whose assets, operations, employees and creditors are all in another jurisdiction. In other words, experience teaches creditors to expect a material subsidiary to race to quick, if not *ex parte*, hearings between (A) the jurisdiction selected by the parent company debtor versus (B) the subsidiary's substantive and operational center of main interests. *Cf.* International Bar Association's proposal Model International Insolvency Co-Operation Act (seen by some as a means to this goal).[17]

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[17] Like Chapter 15 and the U.N. Model Law, the EIR applies *in theory* only on a *unitary* basis, entity by entity, without regard to the affiliates. While there is a rebuttal presumption of the place of company registration as the center of main interests for the EIR, prior to *Parmalat*, EU cases seem summarily (and often on an *ex parte* basis) in practice to rebut that presumption, so as to preserve the decision court's foreign main proceeding status, even though its only material connection appears to be through affiliates in foreign main proceedings there or other economically unimpressive administrative control bases. *See, e.g.*, *Parkside Flexibles SA* (a Polish company with Polish assets, operations and creditors successfully filed for an English administration order); *Ci4net.com* (similar English administration order for Delaware and New Jersey registered and based companies). The nature and extent of change after *Parmalat* is debatable, depending on the skill of the debtor in manipulating the facts on which the courts bases its decision.

Indeed, "*ex parte* filing tactics" for the foreign main proceedings with affiliates have succeeded in consolidated foreign main proceedings which critics charge ignored the realities of individual affiliates' economic centers of main interest on the basis of the location of operations, assets, employees and creditors. Consider some further examples:

1. *Enron Directo*, an affiliate of the English Enron Powers Operations Ltd. and a *sociedad limitada* organized in Spain and operating there, filed for administration *ex parte in London* without notice to creditors, effectively preventing the Spanish creditors (and employees) from challenging the English decision in Spain (the substantive center of main interests on the basis of the location of operations, assets, employees and creditors).

2. *Re Daiytek*, [2003] A11 ER 312, involved affiliates of an English parent filing for English administration orders, even though the center of main interests was apparently in Germany (as to the German companies) and France (as to the French company). Challenges in Germany and France were ultimately unsuccessful, because their lower courts lost to London the race to filing and first hearing on the issue.

3. *Collins & Aikman*, the U.S. parent filed U.S. Chapter 11 and later filed in the UK, and 24 affiliates located in 10 EU countries were placed into UK administration as the "main" proceeding, despite the fact that their assets, operations and creditors were often localized in their respective home countries, based upon the UK interpretation of the "center of main interests" as the location of their intermediate parent merely performing consolidated administrative functions, such as cash management, human resources management, information systems, sales, etc. (Under this approach, all the parent management would have to do to gerrymander a favorable forum is to shift to intermediate parent's administrative functions, which may surprise local creditors of the subsidiary whose assets, liabilities and substantive operations are all local.)

U.S. creditors should ask the following three related Chapter 15 questions, among others:

1. To what extent can they effectively relitigate, in the recognition hearing in the U.S. Chapter 15 case, their arguments under § 1517(b)(1) that the "foreign main proceeding" venue is not the center of main interests of the U.S. subsidiary or the foreign-domiciled subsidiary with material U.S. assets and operations? *See* §§ 1515-1527.

2. To what extent can U.S. creditors effectively use those arguments in the first filed Chapter 15 case to oppose the foreign representative's motions for other relief (*e.g.*, §§ 1519(a)(3) and 1521(a)(7)), such as to enjoin U.S. creditors from filing an involuntary U.S. Chapter 11 or 7 case (*e.g.*, §§ 1528 and 1529(2))?

3. What will be the outer-boundary for what such a "foreign main proceeding" venue can "legally engineer" to attract such foreign main proceeding filings and still qualify as a foreign proceeding under § 1502(4)? *See, e.g.*, how much would

have to be added to change the result in *In re Tam*, 170 B.R. 838 (Bankr. S.D.N.Y. 1994) (voluntary liquidation by shareholders of a Cayman Island corporation was not a "foreign proceeding" under former § 304)?

The fact that experts can debate both sides of these questions suggests the need for clarification, depending on the answer, reforms, in Chapter 15.

III. THE THEORY VS. PRACTICE OF OPENING THE FOREIGN MAIN PROCEEDING FOR A U.S. SUBSIDIARY OF A FOREIGN PARENT OR AFFILIATE IN A RELATED FOREIGN MAIN PROCEEDING

The debtor's "foreign main proceeding" (*i.e.*, where the "center of its main interests" is located under § 1502(4)) is the power position desired by many countries, but that decision may, in practice, be the subject of foreign shopping by debtors in an affiliated group for strategic results, with the goal of targeting U.S. assets to turn over to the foreign main proceeding. Some foreign main proceeding selections will predictably result in the loss of U.S. creditor recoveries compared to both (i) a U.S. bankruptcy (even a U.S. Chapter 7), and (ii) prior U.S. practice under former § 304. The key factors are numerous and include:

1. foreign priority and tax laws and nonavoidable statutory liens which may dilute U.S. creditor recoveries from the foreign main proceeding; *See Government Tax Priorities in Bankruptcy Proceedings*, Report of the International Insolvency Institute's Committee on Tax Priorities in Bankruptcy (March 2006) (analysis of the tax priority laws in 35 countries); "Should the Sovereign Be Paid First? A Comparative Analysis of the Priority for Tax Claims in Bankruptcy, 74 AM. BANKR. L.J. 461 (2000); "Employee Entitlements," a report of INSOL International, describing the treatment of wage and benefit claims under the insolvency laws of 24 countries;

2. foreign priority laws and nonavoidable statutory liens may even strip the value off the U.S. creditor liens on U.S. collateral transferred to the foreign main proceeding, whether by involuntary subordination under foreign law or by other means. *See*, *e.g.*, the prior footnote discussing China's new draft bankruptcy law. The minority of former § 304 cases protecting U.S. secured creditors may no longer protect them under Chapter 15, a position applauded by "universalist" academics promoting Chapter 15 and the U.N. Model Law. *See*, *e.g.*, *In re Treco*, 240 F.3d 148 (2nd Cir. 2001)(no turnover to Bahamanian liquidators under former § 304, where that foreign law's administrative claims would be senior to the U.S. secured creditor, and, in effect, strip the secured creditor's lien); *In re Toga Mfg., Ltd.*, 28 B.R. 165 (Bankr. E.D. Mich. 1983) (denying § 304 turnover to strip U.S. lien in Canadian proceeding);

3. the foreign law equivalents of substantive consolidation, whether *per se* or through claims disallowance equivalence, without protection of U.S. creditors

equivalent to U.S. law (*e.g.*, allowing creditors of a foreign parent to keep cash and liquid assets fraudulently transferred from the U.S. subsidiary);[18]

4. shielding affiliates and insiders from liabilities to steer recoveries away from U.S. creditors (*e.g.*, *Maxwell* preference immunity for foreign transferees);

5. many other legal or more questionable maneuvers, including (in some places) political or even religious (*e.g.*, interest can violate Islamic rules) decision-making and corruption; and

6. the foreign representative of foreign creditors seeking to move U.S. assets to the foreign main proceedings (*e.g.*, §§ 1521, 1522), and the U.S. Chapter 11 creditors committee can be affected by the clash over treatment of foreign creditors in the U.S. case, including as to the U.S. Committee's new duties under § 1102(b)(3) to share information more broadly.

For Chapter 15 purposes, the key question is whether the U.S. bankruptcy court will simply accept under § 1517(b)(1) an erroneous foreign main proceeding decision of this kind (*e.g.*, ignoring the location of operations, assets, employees, and creditors in favor of the location of the controlling parent company), or whether U.S. creditors can dispute in the U.S. Chapter 15 court effectively on the real merits the status of the foreign representative as representing the "foreign main proceeding." In theory, U.S. challenges are possible, but this may be a tough case to win, because even a flawed foreign main proceeding quickly becomes, in practice, the de facto foreign main proceeding, as and when everyone gradually begins to treat it as such.[19] *See* the earlier discussion of the London/EU precedents and the quest by some for the ideal, so-called "Foreign Delaware Extreme," foreign main proceeding venue. *See* § 1508, requiring uniform interpretations that include the pro-parent "London cases."

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[18] For example, the Spanish Insolvency Act (Ley 22/2003, de Julio, Concursal) subordinates what U.S. creditors would analogize to "insider claims," except the "related to" test for subordination has a low threshold (10%, or 5% in publicly listed companies). Thus, creditors of a "related" company can be disappointed when they try to recover claims, including those for transfers designed to aid the parent's creditors at the expense of the subsidiary's creditors. This could have surprising consequences under a "center of main interest" test that allows a Spanish intermediate holding company to arrange joint filings in Spain for subsidiaries actually centered in other EU countries. See the discussion above of the "first to file wins" lessor of the London cases under the EIR.

[19] U.S. courts, reacting to concerns about comity and universally touted by academics and echoed in Chapter 15, may be reluctant to "second guess" even an incorrectly self-declared, foreign main proceeding, especially when the result may be that the real center of foreign main interest cannot then step forward to claim its rights. For example, the EIR generally does not seem effectively to allow correction of incorrect *ex parte* decisions by the winner of the race to initial decision. As a result, strategically selected foreign main proceedings can be expected to occur through forum-shopping, and perhaps even through *Winn Dixie*-type, last-minute creation of affiliates to manipulate jurisdiction for the filing. That reality will magnify the possible risks from Chapter 15 for U.S. creditors, while creating opportunities for buyers of foreign distressed debt, who may be able to influence or control the foreign main proceeding.

IV. SOME OTHER STRATEGIC CONSIDERATIONS FOR CHAPTER 15 FILINGS

A. General Comments

To avoid the risk of lesser than expected recoveries of U.S. secured and unsecured creditors on account of Chapter 15, U.S. creditors can be expected more often to protect themselves by racing to file U.S. involuntary Chapter 11 (or even 7)[20] cases before the foreign representative in the foreign main proceeding files the U.S. Chapter 15 case. Risk of lower-than-traditional recovery from U.S. subsidiaries or ventures of foreign firms predictably will inspire such defensive tactics. For example, if U.S. creditors could have recovered by U.S. process or bankruptcy a high percentage of debt from a U.S. subsidiary but for the U.S. assets (or even control of the U.S. assets) shifting offshore to the foreign main proceeding (where foreign creditors' claims and liens materially dilute U.S. creditor recovery, especially in foreign main proceedings with extensive tax, employee, and other priority claims and statutory liens), U.S. creditors will begin to race to file involuntary U.S. Chapter 11's or 7's to reduce such risk.

While such involuntary bankruptcies may be economically undesirable from a global perspective, Chapter 15 (like the U.N. Model Law on which it is based) has too few, reliable safeguards for many exposed creditors to be willing to risk delay and losing the race discussed above. This is especially true as aggressive debtor counsel (often based in the U.S.) explore with local foreign professionals and business interests the possibility of creating what some call a "Foreign Delaware Extreme" forum for their ideal foreign main proceedings. As discussed above, the strategy is to find a forum where an intermediate holding company can be created with sufficient administrative and supervisory functions for control over the U.S. subsidiaries or U.S. assets in order to purport to justify the concurrent filing of foreign main proceedings for those entities, applying, for example, the EMTEC "London case" precedents now being created for that parent control strategy under the EIR. Because foreign main proceedings are "good for business" locally and can be selected for favorable results for the filers, critics believe that only a plenary U.S. Chapter 11 or 7 case filed before the Chapter 15 case can create an effective counter-forum to attempt to provide protection for the U.S. creditors from the foreign main proceeding. Stated another way, because Chapter 15 reduces the bargaining leverage of U.S. creditors for negotiating the traditional cross-border accords, U.S. creditors need involuntaries to recreate that lost leverage. Rather than have racing U.S. involuntary petitions disputing with foreign main proceedings, a better approach may be to reduce provocations inspiring the U.S. creditors' concerns by reasonable clarifications of, or amendments to, Chapter 15.

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20 While sophisticated U.S. creditors have significant concerns about disappointing results in Chapter 7 cases, they may start increasing their use of Chapter 7, especially if they can expect to elect their choice of trustee under § 702. However, most involuntary filings will use Chapter 11.

B. U.S. Creditors' Race To the Courthouse For U.S. Involuntary Bankruptcies Before Chapter 15 Filings and Foreign Discharge Issues

U.S. creditors have greater rights versus foreign representatives under Chapter 15, if there is a U.S. Chapter 11 or 7 pending before the Chapter 15. *Compare* § 1529(1) (limiting the impact of §§ 1519, 1521 and 1520) versus § 1529(2). *See also* §§ 1528 and 1529. Section 1531 creates a presumption that the debtor is generally not paying its debts as such debts become due under § 303, where the foreign main proceeding is recognized in Chapter 15. U.S. creditors anticipating a foreign main proceeding of their debtor or its parent may now be more motivated to race to file a U.S. involuntary bankruptcy sooner, especially because of the risk of being enjoined from a subsequent involuntary filing by the Chapter 15 court, despite §§ 1528 and 1529. *See also* the automatic stay in §1520(a)(1).

Some professionals planning foreign main proceedings strategically also have considered whether they should conclude the case and obtain a foreign discharge in the foreign main proceeding, and only then file Chapter 15 to enforce that foreign discharge when it may arguably be too late then to contest it there or, as a practical matter, here in the U.S. For example, the foreign main proceeding affiliates may engage in provocative maneuvers that diminish U.S. assets and then obtain a discharge therein. Consider the following hypothetical example:

(a) the foreign parent converts U.S. collateral (*e.g.*, sells U.S. subsidiary assets and transfers funds offshore) or takes U.S. subsidiary funds in an avoidable transfer. Then the foreign main proceeding disallows the U.S. claims and issues a discharge to those foreign affiliate transferees (even without participation by the U.S. creditors);

(b) then, to close out the case, the foreign representative may file a U.S. Chapter 15 in order to enforce the discharge by enjoining U.S. creditor action; and

(c) for a defense to this (and other maneuvers in the foreign main proceeding), a U.S. Chapter 11 or 7 case may be commenced involuntarily in the U.S. early and in time to liquidate the claim in the U.S. first before the foreign discharge and Chapter 15. *See* discussion in Section II. above. For example, if the foreign main proceeding parent debtor caused a transfer of funds from the U.S. subsidiary to the parent before or during the foreign main proceeding, the U.S. creditor might at least wish to establish a preference or fraudulent transfer claim judgment in the U.S. to use in the foreign main proceeding. *But see Maxwell* (rejecting such tactics in certain circumstances). Otherwise, the court or administrator in the foreign main proceeding may use local law or other means to disallow the U.S. subsidiary claim there, in effect declining to share the diverted U.S. assets with the U.S. subsidiary victim or its creditors.

Strategic and legal questions abound in this context with comparatively little modern court precedent. For example, consider questions such as: Will U.S. courts apply rules like those in Principles 26 and 27 of the American Law Institute, *Principles of Cooperation Among* *the NAFTA Countries* (2003), now being updated with collaboration from the International Insolvency Institute? There, the NAFTA main proceeding court approves a Plan of Reorganization, and if there is no parallel proceeding pending in the other NAFTA countries, that Plan of Reorganization binds:

(a) the debtor and every creditor who "participates in any way" in the main proceeding, such as by:

i. filing a claim;

ii. voting; or

iii. accepting a distribution of money or property under the Plan (Principle 26); and

(b) every unsecured creditor who (i) was given adequate individual notice of the case, and (ii) who would be considered within the jurisdiction of the courts in the ordinary commercial matters under the law of the main proceeding with respect to that creditor's type of claim.

See generally Roberts v. Picture Butte Muni Hosp. (1998) 64 Alta. L.R. (3d) 218 (recognizing U.S. bankruptcy proceeding for Dow Corning and enforcing its plan against Canadian tort plaintiffs); *Canada S. Ry. Co. v. Gebhard*, 109 U.S. 527 (1883) (Canadian scheme of arrangement enforced against New York bondholders).

Will U.S. courts expand prior comity and § 304 precedents in now enjoining U.S. creditors from enforcing claims contrary to foreign main proceeding plans (analogous to U.S. plans of reorganization)? For example, to what extent does the fairness of the law and process in the foreign main proceeding matter? *See generally In re Bd. of Directors of Hopewell Int'l Ins. Ltd.*, 238 B.R. 25, 41 (Bankr. S.D.N.Y. 1999), *aff'd* 275 B.R. 699 (Bankr. S.D.N.Y. 2002) (UK/Bermuda scheme of arrangement enforced against U.S. creditors with injunctions, emphasizing necessity and counterparty acquiescence); *In re Bd. of Directors of Multicanal*, 314 B.R. 486 (Bankr. S.D.N.Y. 2004), *aff'd in part*, 331 B.R. 537 (Bankr. S.D.N.Y. 2005) (requiring a U.S. securities fairness hearing before enforcing an Argentinean Acverdo Preventivo Extrajudicial ("APE") prepackaged plan equivalent with injunctions against U.S. creditors, after requiring the APE to correct the discrimination against certain bondholders).

Because enjoining U.S. creditors from actions contrary to foreign main proceeding plans may not be automatic in Chapter 15 (§ 1520), the U.S. Bankruptcy Court in a Chapter 15 can be asked for that as "appropriate relief" under § 1521, but only if such court finds under § 1522(a) that "the interests of creditors" (and certain others) are "sufficiently protected." But what law applies in that debate? *See* EIR Art. 17 and *Parmalat* (requiring all EU states to apply the law of the main proceeding for various purposes) versus UNCITRAL Model Law on Cross Border Insolvency Ch. 3, art. 20 (1997) (applying the local rule instead of the main-proceeding rule for injunctions).

Does a discharge, or do certain other orders in the foreign main proceeding, earn recognition as *res judicata* (*e.g.*, as in an in rem judgment, such as the debt discharge in

Tennessee Student Assistance Corp. v. Hood, 541 U.S. 440 (2004)), or does Chapter 15 now pre-empt the field as the sole basis for enforcement of a foreign discharge or certain other orders? If the res judicata argument prevails, independently, then even the modest § 1522 "sufficient protection" for creditors requirement may be evaded, because res judicata arguably does not include a fairness inquiry.

How much can U.S. creditors depend on the narrow, § 1506 public policy exception for protection from injustice in the foreign main proceeding? For example, will U.S. courts enforce foreign main proceeding decisions against U.S. creditors through Chapter 15 that would not be enforceable in the U.S. under the Uniform Foreign Money-Judgment Recognition Act § 4, 13 U.L.A 58-59 (2002) ("A foreign judgment is not conclusive if . . . judgment was rendered under a system that does not provide impartial tribunals or procedures compatible with the requirements of due process of the law . . .")?

Will U.S. courts now allow U.S. assets to be turned over via Chapter 15, where the foreign main proceeding result will be to strip or subordinate U.S. liens or significantly dilute U.S. claims behind vast priority or administrative claims or statutory senior liens not applicable in the U.S.? *See, e.g., In re Treco*, 240 F.3d 148 (2nd Cir. 2001) (no turnover to Bahamanian liquidators under former § 304, where that foreign law's administrative claims would be senior to the U.S. secured creditor, and, in effect, strip the secured creditor's lien); *In re Toga Mfg., Ltd.*, 28 B.R. 165 (Bankr. E.D. Mich. 1983) (denying § 304 turnover to strip U.S. lien in Canadian proceeding).

V. SOME ILLUSTRATIVE CHAPTER 15 CHANGES OF POSSIBLE CONCERN TO U.S. CREDITORS, AND THREE SUGGESTED CLARIFICATIONS AND REFORMS

Consider one of many possible examples to illustrate the concerns inspiring the following suggested clarifications and reforms. A major U.S.-based multi-national company in distress sells off to a foreign buyer a division composed of U.S. and foreign operating subsidiaries with many employees, assets and creditors in each country, and the buyer entity further leverages each affiliate with substantial secured and unsecured debt held by creditors in each such country. The foreign buyer uses strategically-located foreign intermediate holding companies to administer and control the various operating subsidiaries consistent with EMTEC. Collaborating foreign representatives and U.S. debtor insolvency counsel file a foreign main proceeding in a chosen foreign country (called "Foreign Delaware Extreme")[21] for the U.S. subsidiaries and selected

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[21] The author intends no insult to Delaware (or New York), and merely uses the term commonly used by professionals seeking the kind of legitimate advantages that they presently enjoy in their Delaware or New York filings. The significance of the "Delaware" reference is that it is a place of incorporation for the debtor (or at least for the foreign, interim holding company used for this forum shopping purpose), without the location of any material number of employees, operating assets or creditors in that forum. The significance of the reference to "Extreme" is that the forum-shopping filers appear to have expectations for more aggressive advantages over U.S. creditors than would be expected in Delaware or any other U.S. bankruptcy forum of choice.

(footnote continued next page)

other foreign subsidiaries. The foreign representatives in such foreign main proceedings immediately file a Chapter 15 case for each U.S. subsidiary, automatically receiving substantial benefits upon "recognition" in the Chapter 15 case (*see* §§ 1515-1520) and also requesting substantial further relief, including, for example: (i) a § 105 injunction against any involuntary bankruptcy petitions by U.S. creditors (§§ 1519(a)(3) and 1521(a)(7)) in case the stay does not apply automatically under § 1520(a)(1); and (ii) transferring the U.S. assets offshore to the foreign main proceeding for distribution under the law of the foreign main proceeding (§ 1521), including cash from the sale of nonmovable U.S. assets sold by the foreign representative in control of the debtor under § 1520.

The U.S. secured and unsecured creditors in the above example fear that the transfer of U.S. assets to the foreign main proceeding in the Foreign Delaware Extreme forum will result in materially lesser recoveries compared to their foreseeable Chapter 11 recoveries. Fears include, among other things, (i) material dilution of U.S. secured and unsecured creditors' recovery potential by larger foreign priority and administrative claims and statutory liens than would apply in U.S. cases, (ii) granting (and, as to automatic Chapter 15 benefits, retaining) many rights for the foreign representative at the expense or prejudice of U.S. creditors based upon decisions in the foreign main proceeding that are procedurally and substantively objectionable without a fair opportunity to dispute them *de novo* in the U.S. Court, (iii) transfer of U.S. assets to the foreign main proceeding for distribution on an objectionable basis without "sufficient protection" in fact, and (iv) other loss of rights as a result of having to participate in the foreign main proceeding where U.S. creditors are exposed to what (by U.S. standards) they regard as unjust or unfair treatment by a foreign court.

A. When the Foreign Representative Seeks to Turn Over U.S. Assets to the Foreign Main Proceeding, U.S. Creditors May Find "Sufficient Protection" to Be Insufficient in Practice

1. Overview of Turnover Concerns

Among the Chapter 15 changes from prior U.S. cross border law (former § 304) and among practices that may be of concern to U.S. creditors, are the following illustrations regarding the turnover of U.S. assets to foreign representatives of foreign main proceedings. Chapter 15 expands the opportunity for the foreign representative of the foreign main proceeding

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By the same token, this Commentary is not directed at criticizing any particular country. However, without addressing any issues of bias, corruption, political influence or other merit factors, it is indisputable that many countries have laws or practices which provide lower recoveries and due process rights than U.S. creditors expect from the U.S. bankruptcy courts, on account of factors, including far larger employee, tax, and other priority and administrative claims and statutory liens in many foreign forums.

The optimist's long-term view of gradual reconciliation among insolvency laws and cooperation is supported by recent insolvency law reforms in many influential countries. However, even with reforms the varying national priorities remain visible. For example, U.S.-style systems still favor the debtor's reorganization for a second chance. The U.K. style remains sensitive to creditors, while the French-style systems favor employees, and systems like those in Russia, China and Brazil prioritize governmental concerns. In any event, the opportunities and reasons for "forum-shopping" remain powerful and appear enduring.

to seek the turnover of U.S. assets to the foreign main proceeding. §§ 1521(b), 1522. The condition to turn over (*i.e.*, that the interests of U.S. creditors must be "sufficiently protected" [*Id.*]) seems to be a weak form of protection, as is the U.S. "public policy" protection in § 1506. (U.S. creditors note that, while "sufficient protection" may sound better than it really is, like U.S. "adequate protection" for U.S. secured creditors under § 361, there is no assured Chapter 15 remedy for "sufficient protection" mistakes comparable to the § 507(b) compensatory, super-priority administrative claim, when the U.S. court errs and U.S. "adequate protection" proves illusory.)

Even before Chapter 15, U.S. courts accommodated foreign representative turnovers under § 304. Despite universalists' academic criticism of U.S. "protectionism," U.S. creditors had, at times, at least a fighting chance to block or condition such turnovers that would predictably have stripped U.S. liens or subordinated the U.S. creditors to huge priority or administrative claims and statutory liens that would not have applied in the U.S. bankruptcy. *See*, *e.g.*, *In re Treco*, 240 F.3d 148 (2nd Cir. 2001); *In re Toga Mfg. Ltd.*, 28 B.R. 165 (Bankr. E.D. Mich. 1983). *See also In re Egeria Societa Per Azioni di Navigazione,* 26 B.R. 494 (Bankr. E.D. Va. 1983); *In re Comstat Consult Services,* 10 B.R. 134 (Bankr. S.D. Fla. 1981). Indeed, even without former § 304, foreign representatives have sometimes been able to use U.S. bankruptcies to collect U.S. assets for foreign bankruptcy estates and then to turn the recoveries over to the foreign main proceeding. *See*, *e.g.*, *In re Axona Int'l Credit & Commerce Ltd.*, 88 B.R. 597 (Bankr. S.D.N.Y. 1988) (Hong Kong liquidator filed involuntary Chapter 7 case in NY against his company under § 303(b)(4) in order both to collect U.S. preferences not recoverable under Hong Kong law and to recover other assets, and then arranged with the U.S. Chapter 7 trustee to "suspend" the U.S. Chapter 7 case under § 305(b) and to direct the turn over of the U.S. assets to the Hong Kong proceeding).

Chapter 15 now facilitates turn over in many ways, which are limited by vague and not very impressive protections for U.S. creditors in §§ 1506 (U.S. "public policy") and 1521(b)/1522 ("sufficient protection"). (As noted above, the real protection for U.S. creditors may be through involuntary U.S. bankruptcy cases, where those can be arranged before the Chapter 15 filing, or where they can be arranged afterward, despite the foreign representatives' predictable use of Chapter 15 to attempt to stay them.) Among the many reasons for foreign directors and managers to desire U.S. assets and subsidiaries to be turned over to their strategically selected foreign main proceeding, are to use U.S. assets as a "peace offering" to certain foreign creditors and, thereby, to reduce the foreign insiders' personal liability concerns, including claims for employees, for taxes, for trading while insolvent exposures, etc.

Under former § 304, turnover disputes included a focus on establishing ownership of the asset as between the foreign representative and the creditor/claimant (*e.g.*, a person whose converted funds were held in a U.S. constructive trust). *See*, *e.g.*, *In re Koreag Controle et Revision S.A.*, 961 F.2d 341 (2nd Cir. 1992) (where Swiss bank currency trader received customer Refco's money, but failed to exchange the currency, NY law was applied to decide ownership before turnover). Now, under Chapter 15, that debate will restart, most strategically when the foreign representative receives a debatable ruling in its favor as to that ownership question from the questionable foreign main proceeding court, which foreign court ruling the foreign representative may then attempt to assert in the U.S. as conclusive. "Universalist" courts may impose difficult proof standards for protecting U.S. creditors from foreign systems dangerous to U.S. creditor rights. *See, e.g.*, *Finanz AG Zurich v. Banco Económico S.A.*, 192 F.3d 240 (2nd Cir. 1999), citing *Baker v. Latham Sparrowbush Assoc.*, 72 F.3d 246, 254 (2nd Cir. 1995) (criticizing *Hourani* and instead requiring focus on actual facts in the individual case, rather than on the problematic general law or rules applicable in the foreign proceeding). However, proving specific judicial abuses in another country is neither easy, nor (in some cases) safe for the witness or complaining creditor. General comparative law analysis is safer and easier. By shifting to such an actual proof-of-abuse test in this manner, the courts would be departing from other U.S. precedents and laws, such as those for recognition of foreign money judgments. *See* Uniform Foreign Money-Judgments Recognition Act (adopted by many U.S. States) (providing many grounds for refusing to enforce foreign judgments, including some focused on the lack of reliable rules of law, lack of impartial tribunals, fraud/corruption, etc.).

2. <u>"Sufficient Protection" Clarification</u>

"Sufficient protection," §§ 1521(b), 1522(a), requires clarification, especially since there is no effective means of correcting a mistake that in fact deprives the U.S. creditor of "sufficient protection." *Compare* Chapter 15 "sufficient protection" *with* 11 U.S.C. § 361 "adequate protection," which partially corrects for judicial mistakes creating creditor losses by granting a super-priority administrative claim under § 507(b). For example, what risk of loss by a U.S. creditor is tolerable under that standard, when its local U.S. recovery opportunity is converted into a different (and often lesser priority) share in the foreign main proceeding? Moreover, because "sufficient protection" should be judged by comparative results when recoveries differ between the local U.S. law versus the foreign main proceeding, the uniform interpretation rule in § 1508 should have less importance in defining "sufficient protection." Because of the comparatively fewer safeguards relating to "sufficient protection" in Chapter 15, that standard should include <u>more</u> than "adequate protection" under § 361, not <u>less</u> protection.

3. <u>Official III Comments on "Sufficient Protection" As Used in §§ 1521 and 1522</u>

The goal of the "sufficient protection" requirement should be to assure that the local U.S. creditor does not receive a lower recovery on account of Chapter 15 than would be reasonably foreseeable in an involuntary Chapter 11 case for the applicable U.S. affiliates and from U.S. assets of the foreign main proceeding debtor. That determination should be made *de novo* on the merits by the U.S. Chapter 15 court after notice and hearing without regard to any rulings in the foreign main proceeding. For example, a U.S. secured creditor does not appear to be receiving "sufficient protection" of its collateral, if such collateral is transferred to a foreign main proceeding where the U.S. creditor's lien is subordinated to foreign statutory or other liens or to senior foreign priority or administrative claims allowed to collect from the collateral.

Furthermore, a court should not find "sufficient protection," if the U.S. secured creditor's recovery from its collateral can be materially impaired in any other manner, compared to what it could reasonably expect in a U.S. Chapter 11 case, such as, for example, by selling free and clear of the lien at an insufficient price without the U.S. safeguards (*e.g.*, the right to a competitive credit bid to assure fair pricing), or by using cash collateral or granting senior "priming liens" without U.S. style safeguards (*e.g.*, replacement liens in sufficient value backed up by § 507(b) super priority administrative claims).

As for unsecured claims of U.S. creditors, their foreseeable, expected recovery from U.S. assets and entities in a Chapter 11 case should not be lessened materially by transfer of assets or control to the foreign main proceeding. For example, "sufficient protection" would not exist where the foreign main proceeding would impair such U.S. recovery expectations by first paying statutory liens or priority or administrative claims in the foreign main proceeding in amounts far in excess of what is allowed for such claims in the U.S. Another example would be where local law or practice would allow any kind of discrimination against the U.S. creditors (or any favoritism for foreign creditors) that would not be permitted in the U.S.

In summary, "sufficient protection" includes within it the requirement for "adequate protection" as defined in 11 U.S.C. § 361. However, sufficient protection requires stronger and broader protections, although, if a U.S. creditor is not "adequately protected," then under no circumstances can it be "sufficiently protected." One of the reasons for the greater breadth of the "sufficient protection" standard is that the safeguards backstopping "adequate protection" under the U.S. Bankruptcy Code are generally lacking under Chapter 15, such as, for example, the absence of a § 507(b) super-priority administrative claim when the court's ruling of sufficient protection proves incorrect.

B. <u>Standards For Recognition of the Foreign Main Proceeding in Chapter 15</u>

In the case of U.S. operating subsidiaries and some foreign entities with substantial U.S. assets, the "center of its main interests" (§1502(4)) or "COMI" may in fact be in the U.S., in theory precluding a "foreign main proceeding" from being "recognized" in the U.S.[22] *See* §§1515-1517. In such cases, the foreign proceeding should be only a "foreign non-main proceeding" under Chapter 15, which is far less problematic for U.S. creditors. If the U.S. creditors win the race with their involuntary bankruptcy filing before the Chapter 15 filing, various tactics may enable those U.S. creditors to prevent incorrect recognition of the foreign proceeding as the "main foreign proceeding." *See* Section IV.A., *supra*. Nevertheless, the incentives of the foreign parties likely will result in many foreign proceedings each classifying itself as a "foreign main proceeding." *See* Section II.F., *supra*, discussing the EMTEC and London cases under the EIR. This situation raises the issue of how and where the question is resolved about whether the U.S. Chapter 15 has to recognize the foreign proceeding as the COMI and "main foreign proceeding" when the foreign court so declares, regardless of whether a plenary U.S. Chapter 11 or 7 case exists.[23]

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[22] Some argue that there must always be a foreign main proceeding when there is a foreign (non-U.S.) debtor. However, Chapter 15 should be clarified to correct that misimpression, if the COMI is in the U.S.

[23] There are different legal and tactical complications for resolving this question in the three alternative contexts:

(1) When a U.S. Chapter 11 or 7 exists for the debtor in the main foreign proceeding at the time when the Chapter 15 is filed; or

(2) When an involuntary Chapter 11 or 7 petition has been filed, but no order for relief has yet been entered by the U.S. bankruptcy court under § 303 when the Chapter 15 is filed; or

(3) When the Chapter 15 is filed first by the foreign representative in the purported main foreign proceeding.

(footnote continued next page)

The law should distinguish between (i) a COMI decision in a purported foreign main proceeding that is done on an *ex parte* or other "quickie" basis, versus (ii) a COMI decision on the merits after a full adversary proceeding on the merits with adequate U.S.-style due process.[24] To be fair and responsive to the U.S. creditor concerns and to reduce pressures for premature tactical litigation in U.S. involuntary bankruptcy cases, the following reforms and clarifications would be desirable:

1. U.S. creditors should be able to contest on the merits *de novo* in an adversary proceeding in the U.S. Chapter 15 (or, if applicable, in any Chapter 11 or 7 case), whether or not the COMI is in the purported foreign main proceeding forum country. Such creditors should not have to participate first in the foreign proceeding or to have litigated the issue there. A U.S. trustee in bankruptcy not participating in the foreign proceeding should *not* prevent objections to the foreign COMI decision from being raised by creditors in the U.S. Chapter 15 case. In other words, the decision on COMI by the foreign main proceeding court should *not* be res judicata and should not otherwise collaterally estop or otherwise preclude the U.S. creditors from establishing that the COMI is in the U.S., thus preventing the recognition of the foreign proceeding as the main foreign proceeding;

2. In the interim, prior to such recognition on the merits in the Chapter 15 case of the foreign representative as representing the main foreign proceeding, the foreign representative should be deemed only to be representing a "foreign non-main proceeding," although on a discretionary basis the foreign representative can apply to the U.S. Chapter 15 court for additional relief; and

3. The adversary proceeding for U.S. recognition should require the foreign representative to defend his or her position and to submit to discovery in the Chapter 15, and the limited appearance and non-submission to jurisdiction under § 1510 should not excuse the foreign representative from what should be his or her burden of proving the COMI for his or her purported foreign main proceeding.

For the purposes of this commentary, the suggested reforms or clarifications should cover all three situations equally, because to apply a different standard in any such situation merely increases the incentives to race for earlier U.S. involuntary bankruptcy petitions in order to attempt to pre-empt recognition of a foreign proceeding as the foreign main proceeding. Because out-of-court global restructurings can often produce the best results, even if an insolvency proceeding is ultimately required, such races to bankruptcy are often economically counterproductive even from a global perspective. However, few large creditors in any country will likely be willing voluntarily to suffer a larger than necessary loss merely to promote abstract goals of global cooperation.

[24] Because of some U.S. creditor concerns about the quality of justice in the courts of some countries, U.S. creditors may be reluctant to engage on the merits in certain foreign proceedings, especially where the procedure lacks U.S. style discovery and due process. Submitting oneself to the jurisdiction of the foreign main proceeding is a serious matter requiring careful analysis and planning. Nevertheless, a U.S. bankruptcy trustee may attempt to combat the foreign main proceeding challenges in that proceeding, and that action raises the question about who else, if anyone, that trustee action binds in the U.S.

C. Clarification of the Right for U.S. Creditors To File A U.S. Involuntary Bankruptcy Petition After A Chapter 15 Filing

As noted above, at present, fear may drive U.S. creditors to file involuntary Chapter 11 or 7 petitions earlier than usual in order to win the present race against the foreign representatives' Chapter 15 filing. *See* Section II.E., *supra*. This is not only a matter affecting the substantive rights of the U.S. creditors exposed to less advantageous rights in the foreign main proceeding and Chapter 15, but this also affects the selection of the U.S. bankruptcy court forum. Generally, U.S. creditors may seek to file involuntaries where the relevant assets are concentrated, or where the debtor's principal U.S. office is located, while the foreign representative can be expected to use affiliate filings and transfer of venue motions in order to position his or her Chapter 15 cases in the Southern District of New York, where the universalist precedents in their favor seem to be the strongest.

At present, there are three alternative arguments about the rights of U.S. creditors to file involuntary U.S. Chapter 11 or 7 cases *after* a Chapter 15 has been filed or recognized in the U.S. as the main foreign proceeding:

1. The stay automatically arising upon the Chapter 15 filing under § 1520(a)(1) prevents the filing of a U.S. involuntary bankruptcy petition;

2. The stay does not arise automatically under § 1520(a)(1), because of § 1528[25] and other provisions which counteract the automatic stay argument. However, the foreign representative may seek a U.S. Chapter 15 court injunction under § 105 to prevent the filing of any involuntary bankruptcy by U.S. creditors. §§ 1519(a)(3) and 1521(a)(7); or

3. U.S. creditors may file an involuntary bankruptcy petition pursuant to §§ 1528 and 303, which result U.S. creditors would like to be clarified, so as to overcome the foreign representative's aforementioned stay and injunction arguments. That is the clarification and reform desired by U.S. creditors critical of Chapter 15.

VI. CONCLUDING COMMENTS

Many provisions of Chapter 15 could be usefully reformed or at least clarified in order to moderate the reactions of U.S. creditors when they begin to understand how the new game will be played by some foreign representatives under Chapter 15. This commentary merely illustrates a few of these suggested reforms or clarifications. Absent a system that preserves U.S. creditors' reasonable recovery expectations, especially those of secured creditors, the fans of Chapter 15 and the U.N. Model Law can expect defensive litigation and tactics by those U.S. creditors who

[25] Somewhat ambiguously, § 1528 appears to allow the bankruptcy filing, although the statute does not specify by whom the filing may be made, a matter requiring clarification to ease the concerns of U.S. creditors. *See also* § 1529(2), which clearly contemplates the filing of plenary U.S. Chapter 11 or 7 cases after the Chapter 15 filing.

will seek to avoid suffering lower recoveries foreseeable on account of Chapter 15. Some of those defenses are briefly addressed here, and other defenses will emerge when the creditors begin to react to their Chapter 15 exposures. However, the best means of achieving the global cooperation goals of Chapter 15, and of reducing the negative effects of such U.S. creditor defenses, are to moderate the magnitude and scope of the provocations to which the U.S. creditors will be reacting. Some suggested compromise approaches are discussed in this commentary.