

Client Alert

U.S. Bankruptcy Code Amendments Affect Ancillary Proceedings: Chapter 15 To Replace Section 304

On April 20, 2005, President George W. Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “Reform Act”) into law. A major component of the Reform Act is to add Chapter 15 to the U.S. Bankruptcy Code. Chapter 15, which is based upon the United Nations Commission for International Trade Law Model Law on Cross-Border Insolvency, will replace Section 304 of the U.S. Bankruptcy Code. It will become effective on October 17, 2005 and will apply to cases filed on or after that date. In many ways, Chapter 15 will significantly change U.S. law as currently reflected in Section 304.

What are the requirements for a Chapter 15 case?

A Chapter 15 case is commenced by the filing of a petition for recognition of a “foreign proceeding.” Thus, like a Section 304 proceeding, the existence of a “foreign proceeding” is a prerequisite to a Chapter 15 case.

What qualifies as a “foreign proceeding”?

The Reform Act defines “foreign proceeding” as “a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.” The new definition differs from the current definition used for Section 304 as demonstrated by the following comparison:

Requisites of a Foreign Proceeding	<u>Under Section 304</u>	<u>Under Chapter 15</u>	<u>Comments</u>
Type of Proceeding	proceeding, whether judicial or administrative, in a foreign country	collective judicial or administrative proceeding in a foreign country, including an interim proceeding, in which the assets and affairs of the debtor are subject to control or supervision by a foreign court	<ul style="list-style-type: none"> • Both definitions include judicial and administrative proceedings. • New definition expressly requires that the proceeding be a “collective” one, which appears to be intended to exclude individual creditor actions, such as attachments. • New definition explicitly requires that the debtor’s assets and affairs be subject to control or supervision of a foreign court, which includes any “authority competent to control or supervise a foreign proceeding.”

Requisites of a Foreign Proceeding	<u>Under Section 304</u>	<u>Under Chapter 15</u>	<u>Comments</u>
Type of Controlling Law	whether or not under a bankruptcy law	under a law relating to insolvency or adjustment of debt	<ul style="list-style-type: none"> New definition requires that the law governing the proceeding relate to insolvency or adjustment of debt; Section 304 definition does not explicitly so require.
Location of Proceeding	in a foreign country in which the debtor's domicile, residence, principal place of business or principal assets were located at the commencement of such proceeding	either debtor's "center of main interests" or debtor's "establishment" (i.e., place of nontransitory operations)	<ul style="list-style-type: none"> New definition does not use the Section 304 terms that the proceeding be pending where the debtor has its domicile, residence, principal place of business, or principal assets. While the new definition itself does not include the terms "center of main interests" or "establishment," those terms are included in the additional definitions of foreign main and foreign nonmain proceeding, the two subdivisions of a foreign proceeding under Chapter 15.
Purpose of Proceeding	for the purpose of liquidating an estate, adjusting debts by composition, extension, or discharge, or effecting a reorganization	for the purpose of reorganization or liquidation	<ul style="list-style-type: none"> While the purpose of the proceeding no longer includes the express concept of "adjusting debts," that concept is incorporated in the type of controlling law involved.

What are the standards for relief under Chapter 15?

Unlike under Section 304, a court will not have to consider the so called Section 304(c) factors (e.g., comity, prejudice) in determining whether to grant relief under Chapter 15. After notice and a hearing, a foreign proceeding would be recognized automatically under Section 1517, unless such recognition would be "manifestly contrary to the public policy of the United States." Moreover, as explained below, if the foreign proceeding qualifies as a "foreign main proceeding," recognition will have immediate and significant effects.

A "foreign main proceeding" refers to "a foreign proceeding pending in the country where the debtor has the center of its main interests." While Chapter 15 does not define "center of its main interests," it contains the presumption that a debtor's registered office is the center of a debtor's main interests. Alternatively, a foreign proceeding can be classified as a "foreign nonmain proceeding," which is one pending in a country where the debtor has an "establishment." An "establishment" is defined as "any place of operations where the debtor carries out a nontransitory economic activity."

Upon recognition of a foreign main proceeding, unlike under Section 304, a number of provisions of the U.S. Bankruptcy Code will apply with respect to the debtor and its property located in the United States. For example, Section 362, which provides for an "automatic stay" of litigation and

collection efforts, will apply and it will no longer be necessary to seek an injunction enjoining creditors from taking actions to collect upon debts or from litigating against the debtor in the U.S. Section 363, governing the use, sale and lease of property, also will apply to transfers of an interest of a debtor in property located in the United States. Recognition of a foreign nonmain proceeding, however, will not trigger the automatic application of these provisions.

What other relief might a court order?

Relief under Chapter 15 is not limited to recognition or, in the case of a foreign main proceeding, the automatic application of certain sections of the Bankruptcy Code to the debtor and its property in the United States. Upon recognition of either type of foreign proceeding, a court may grant “any appropriate relief” under Section 1521,¹ which could include (i) injunctions broader than the automatic stay, (ii) discovery concerning the debtor’s assets, liabilities, and affairs, and (iii) additional relief available to a trustee. The list is not exhaustive and the courts retain the flexibility to fashion relief best suited under the circumstances. Presumably, as currently permitted under Section 304, a court could enjoin improper draws on letters of credit, or attempts of creditors to get access to trusts and escrows in excess of amounts permitted under the underlying contracts.

Upon recognition of either type of foreign proceeding, a court may also “entrust the distribution of all or part of the debtor’s assets located in the United States to the foreign representative ... provided that the court is satisfied that the interests of creditors in the United States are sufficiently protected.” It remains to be seen if U.S. courts will permit the turnover of assets that are subject to a lien of a U.S. creditor. A court, however, cannot authorize the use of U.S. avoidance powers in a case under Chapter 15.

In response to lobbying by the insurance industry, Chapter 15 expressly prohibits courts from granting relief “with respect to any deposit, escrow, trust fund or other security required or permitted under any applicable State insurance law or regulation for the benefit of claim holders in the United States.” This prohibition should be of little practical effect as trust funds were rarely attacked in Section 304 cases. The treatment of such funds in cases under Chapter 15 should continue to be the result of negotiations with the relevant state agency, as opposed to court intervention.

In order to grant “appropriate relief,” a court must conclude that the relief is “necessary to effectuate the purpose of [Chapter 15] and to protect the assets of the debtor or the interests of creditors.” Although not required, a court may consider the Section 304(c) factors in determining whether to grant relief under Chapter 15. Where relief is sought in connection with a foreign nonmain proceeding, “the court must be satisfied that the relief relates to assets that, under the law of the United States, should be administered in the foreign nonmain proceeding or concerns information required in that proceeding.”

¹ According to the legislative history of Chapter 15, “[t]his section does not expand or reduce the scope of relief currently available in ancillary cases under sections 105 and 304.”

Can a court grant relief prior to formal recognition?

Under Section 1519, a court may grant injunctive relief, order discovery or other additional relief available to a trustee on a provisional basis prior to recognition, if it “is urgently needed to protect the assets of the debtor or the interests of creditors.” This could include, for example, immediate emergency relief in the form of a temporary restraining order where there is a risk of “immediate and irreparable harm.”

Are foreign insurance companies eligible for relief under Chapter 15?

The short answer is yes. Certain entities are expressly precluded from obtaining relief under Chapter 15. Under Section 109(b) of the U.S. Bankruptcy Code, railroads, domestic and foreign insurance companies, domestic banks, and foreign banks that have a branch or agency in the U.S. cannot be a debtor in a U.S. plenary case. Chapter 15 incorporates Section 109(b) and provides that relief under Chapter 15 is not available for those entities, but then specifically carves out from that exclusion foreign insurance companies. Thus, a foreign insurance company may qualify for a case under Chapter 15. Presumably, a branch of a foreign insurance company could also qualify, albeit as a foreign nonmain proceeding under Chapter 15.

Would a scheme of arrangement under § 425 of the Companies Act qualify as a “foreign proceeding”?

Although cases decided under Section 304 are not necessarily applicable to Chapter 15, a court may consider such cases as persuasive especially where the court is considering language in Chapter 15 that is identical or similar to language contained in Section 304.² Under Section 304, schemes of arrangement under § 425 of the English Companies Act (and similar statutes) have been found to qualify as foreign proceedings. *In re Board of Directors of Hopewell Inter'l Ins. Ltd.*, 238 B.R. 25, 48-52 (Bankr. S.D.N.Y. 1999), *aff'd*, 275 B.R. 699 (S.D.N.Y. 2002). The scheme process was found to qualify as a foreign proceeding under Section 304 given that it is a judicial proceeding to adjust assets and debts. *See Hopewell*, 275 B.R. at 706. Based upon this rationale, a court should conclude that, for purposes of Chapter 15, a scheme of arrangement is:

- a collective judicial proceeding in a foreign country
- in which the assets and affairs of the debtor are subject to supervision by a foreign court; and
- for the purpose of reorganization or liquidation.

A court should also conclude that the Companies Act is a law relating to insolvency or adjustment of debt and, as such, a scheme of arrangement under that law should satisfy that criterion. Thus, a

² According to the legislative history of Chapter 15, “[w]hile section 304 is repealed and replaced by chapter 15, access to the jurisprudence which developed under section 304 is preserved in the context of new section 1507.”

court considering a petition for recognition of a scheme of arrangement under Chapter 15 should conclude that it qualifies as a foreign proceeding.

Would a solvent scheme of arrangement qualify as a “foreign proceeding”?

To qualify as a foreign proceeding under Chapter 15, a solvent scheme would have to be (1) under a law relating to insolvency or adjustment of debt and (2) for the purpose of reorganization or liquidation. As to the first point, a solvent scheme in England is governed by the Companies Act which U.S. courts should recognize as a law relating to insolvency or adjustment of debt. As to the second point, the court in *Hopewell* described the solvent scheme in that case as being analogous to a plan of reorganization under Chapter 11 of the U.S. Bankruptcy Code. As such, a court should conclude that reorganization (or even possibly liquidation) is the purpose of a solvent scheme of arrangement, hence meeting the second criterion of a foreign proceeding. Thus, as under existing law, solvent schemes of arrangement should qualify as foreign proceedings.

Would a Part VII scheme of transfer qualify as a “foreign proceeding”?

The United States Bankruptcy Court for the Southern District of New York recently denied a request for recognition under Section 304 of a scheme of transfer proposed under Part VII of the Financial Services and Markets Act 2000 (“FSMA”). *In re Rose*, 318 B.R. 771 (Bankr. S.D.N.Y. 2004) (the “Aviva decision”). Parsing through the definition of foreign proceeding applicable to Section 304 proceedings, the court concluded that a scheme of transfer did not qualify as a “reorganization” for purposes of qualifying as a foreign proceeding.³ In order to qualify under Chapter 15, a court would have to conclude that a scheme of transfer is “for the purpose of reorganization or liquidation.” Moreover, a court would have to find that the FSMA is a law relating to insolvency or the adjustment of debt. Given the difficulty in meeting those two criteria, the result under Chapter 15 might well be the same.

Where is venue proper for a Chapter 15 case?

Unlike venue of an ancillary proceeding under Section 304, venue of a case under Chapter 15 is not generally dependent upon the relief requested, but rather on the debtor’s connections to the United States. Venue of a Chapter 15 case would be proper in the district in which the debtor has its principal place of business or principal assets in the United States. If the debtor does not have a place of business or assets in the United States, venue would be proper in the district in which an action or proceeding is pending against the debtor. If there is no litigation pending against the debtor in the United States, venue would be proper in the district “in which venue will be consistent with the interests of justice and the convenience of the parties, having regard to the relief sought by the foreign representative.” In the case of foreign insurance companies where their main asset is

³ On April 19, 2005, Catherine Geraldine Regan, as Foreign Representative of Riverstone Insurance (UK) Limited and Sphere Drake Insurance Limited filed a petition under Section 304 seeking recognition of a scheme of transfer proposed under Part VII of the FMSA. We will see if the second time is the charm.

reinsurance in the U.S., venue would be proper in the district in which the majority of the debtor's reinsurers are located, which has often been the Southern District of New York.

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