Chapter 15 Recognition Mandatory and Fully Encumbered Assets Are "Property of the Debtor" Protected by Automatic Stay

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More than eight years after chapter 15 of the Bankruptcy Code became effective in 2005, the utility of a chapter 15 filing in a U.S. bankruptcy court to protect a foreign debtor and its assets from legal action or creditor collection efforts in the U.S. is undisputed. However, whether relief under chapter 15, as distinguished from its precursor, section 304, is mandatory if a foreign proceeding otherwise satisfies the statutory criteria for recognition is a question that has received relatively little scrutiny.

The U.S. Court of Appeals for the Third Circuit recently filled that void in cross-border bankruptcy jurisprudence when it handed down its first ruling in a chapter 15 case. In *In re ABC Learning Ctrs. Ltd.*, 2013 BL 228042 (3d Cir. Aug. 27, 2013), the court held that an Australian liquidation proceeding should be recognized as a "foreign main proceeding" under chapter 15 even though: (i) the debtor's assets were fully encumbered by liens; and (ii) an Australian receivership was pending concurrently with the liquidation. The court also ruled that the automatic stay prevented the efforts of an unsecured judgment creditor to levy on the debtor's U.S. assets because, although fully leveraged, the assets were "property of the debtor."

The Purpose of Chapter 15

Chapter 15 is unique among the chapters of the Bankruptcy Code in expressing a mission statement. Section 1501 provides that the purpose of chapter 15 is "to provide effective

mechanisms for dealing with cases of cross-border insolvency" consistent with the following objectives:

- Cooperation between U.S. and non-U.S. courts and related functionaries;
- Greater legal certainty for trade and investment;
- Fair and efficient administration of cross-border cases in a way that protects the interests of all interested parties;
- Protection and maximization of the value of the debtor's assets; and
- Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

Procedures and Relief Under Chapter 15

Under chapter 15, the duly appointed representative of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." "Foreign representative" is defined in section 101(24) of the Bankruptcy Code as "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding."

"Foreign proceeding" is defined in section 101(23) of the Bankruptcy Code 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.

More than one bankruptcy or insolvency proceeding may be pending with respect to the same foreign debtor in different countries. Chapter 15 therefore contemplates recognition in the U.S. of both a "main" proceeding—a case pending in the country where the debtor's "center of main

interests" is located—and "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment," i.e., "any place of operations where the debtor carries out a nontransitory economic activity."

Section 1517 of the Bankruptcy Code provides that, subject to section 1506, "an order recognizing a foreign proceeding *shall* be entered" (emphasis added) if the proceeding qualifies as a foreign main or nonmain proceeding, the foreign representative is "a person or body," and the petition itself complies with the evidentiary requirements set forth in section 1515. Section 1506 states that "[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."

If a U.S. bankruptcy court recognizes a foreign main proceeding under chapter 15, section 1520(a)(1) of the Bankruptcy Code provides that actions against the foreign debtor or "property of the debtor that is within the territorial jurisdiction of the United States" are stayed under section 362—the Bankruptcy Code's "automatic stay."

Following recognition of a foreign main or nonmain proceeding, the bankruptcy court may also provide "additional assistance" to a foreign representative. This can include injunctive relief or authority to distribute the proceeds of all or part of the debtor's U.S. assets. However, in granting such relief, the court must conclude, "consistent with the principles of comity," that such assistance will reasonably ensure, among other things, the just treatment of creditors and other stakeholders, the protection of U.S. creditors against prejudice and inconvenience in pursuing

their claims in the foreign proceeding, and the prevention of fraudulent or preferential disposition of the debtor's property.

In *ABC Learning*, the Third Circuit made its initial foray into chapter 15 territory when it considered, among other things, whether a bankruptcy court properly entered an order recognizing an Australian liquidation proceeding commenced on behalf of a debtor whose assets were fully encumbered.

ABC Learning

ABC Learning Centres Ltd. ("ABC") was an Australian company that provided child-care and educational services in Australia, the U.S., New Zealand, the U.K., Southeast Asia, and the South Pacific through its 38 subsidiaries. ABC conducted business in the U.S. principally through its U.S. subsidiaries, ABC Developmental Learning Centres (USA) Inc. ("ABC USA") and the Learning Care Group, which, through its Tutor Time subsidiary, was a for-profit child-care and early-education provider with more than 1,000 corporate and franchise child-care centers located throughout the U.S.

In June 2008, RCS Capital Development, LLC ("RCS"), an Arizona limited liability company created for the purpose of developing child-care facilities in the United States for ABC, contracted with ABC USA to develop child-care facilities in the U.S.

In October 2008, RCS sued ABC USA in Arizona state court for breach of contract. On May 14, 2010, RCS won a jury verdict against ABC USA in the amount of approximately $50 million. The Arizona court of appeals upheld the award on appeal in June 2012.

On November 6, 2008, ABC's directors commenced voluntary administration proceedings under Australian law for ABC and each of its Australian subsidiaries. The directors also appointed administrators to determine whether ABC should be restructured or liquidated.

Entering into voluntary administration breached ABC's loan agreements with its secured creditors, who exercised their right under Australia's Corporations Act of 2001 to appoint a receiver for the purpose of realizing on ABC's assets. Those assets were fully encumbered.

In March 2009, the receiver sued RCS and certain other defendants in Nevada state court for $30 million, asserting, among other things, a constructive-trust claim over properties that the defendants had purchased with ABC's funds.

ABC's directors voted to enter Australian liquidation proceedings on June 2, 2010, and appointed two of the company's administrators as liquidators. The liquidators' charge was to realize assets for the benefit of all creditors, to investigate secured-creditor liens, and to pay any surplus remaining after the payment of secured claims ratably to unsecured creditors. The receivership operated in tandem with the liquidation proceedings. ABC's liquidators authorized the receiver to manage and operate ABC.

On May 26, 2010, 12 days after the jury verdict in the Arizona action was rendered in favor of RCS, ABC's liquidators petitioned the Delaware bankruptcy court for an order recognizing ABC's Australian liquidation as a foreign main proceeding under chapter 15. The stated purpose

of the petition was to protect ABC's U.S. assets from RCS's judgment. RCS objected to recognition and the imposition of the automatic stay. In the alternative, RCS moved for relief from the stay so that it could reduce its jury verdict in the Arizona action to judgment and assert a setoff of the judgment as a defense in the Nevada litigation.

The bankruptcy court entered an order recognizing the Australian liquidation as a foreign main proceeding on November 15, 2010. It also ruled that the automatic stay applied to ABC and its properties within the territorial United States. *See In re ABC Learning Centres Ltd.*, 445 B.R. 318 (Bankr. D. Del. 2011). Among other things, the bankruptcy court found that the Australian liquidation proceeding met the definition of "foreign proceeding" under section 101(23) of the Bankruptcy Code because: (i) it was "primarily administrative in character, and at times judicial in character"; (ii) it was a "collective" proceeding; and (iii) it was being conducted under the "control or supervision" of a foreign court. The court ruled further that the liquidation proceeding should be evaluated separately from the concurrently pending receivership. It also concluded that recognition was not "manifestly contrary" to U.S. public policy, rejecting RCS's contention that the liquidators were seeking recognition of the liquidation at the behest of the receiver and the secured creditors for the purpose of gaining an unfair advantage in the Arizona and Nevada lawsuits.

However, the court granted RCS's motion for relief from the automatic stay for the limited purpose of reducing the Arizona verdict to judgment and asserting the resulting judgment as a setoff in the Nevada litigation. On appeal, the district court upheld the recognition ruling on June

18, 2012. RCS, which filed for chapter 11 protection in Arizona in October 2011, appealed to the Third Circuit.

The Third Circuit's Ruling

A three-judge panel of the Third Circuit affirmed. Writing for the court, circuit judge Anthony J. Scirica examined the provenance of chapter 15 in some detail, explaining that chapter 15 is closely patterned after the Model Law on Cross-Border Insolvency (the "Model Law") promulgated in 1997 by UNCITRAL, the U.N. Commission on International Trade Law. Like the Model Law, Judge Scirica explained, chapter 15 "embraces the universalism approach," whereby a multinational bankruptcy is treated as "a single process in the foreign main proceeding, with other courts assisting in that single proceeding."

He also explained that chapter 15 replaced section 304 of the Bankruptcy Code, which gave U.S. bankruptcy courts discretion to grant a limited range of ancillary (principally injunctive) relief by way of assistance to the duly appointed representatives of foreign debtors with U.S. assets. Such relief was to be granted (or withheld) in accordance with a statutory checklist of guiding principles designed to inform the courts' discretion, the scope of which was considerable. *See* 11 U.S.C. § 304(e) (repealed 2005).

By contrast, Judge Scirica emphasized, if a foreign proceeding satisfies the criteria set forth in section 1502 of the Bankruptcy Code, recognition of the foreign proceeding under chapter 15 is required. Mandatory recognition of qualifying insolvency proceedings, Judge Scirica wrote, "fosters comity and predictability, and benefits bankruptcy proceedings in the United States that seek to administer property located in foreign countries that have adopted the Model Law."

Judge Scirica then examined voluntary administration and receivership under Australian law. He explained that a company's directors may initiate either reorganization or liquidation proceedings under an administration, and in the case of a liquidation, the liquidators are entrusted with collecting and distributing the company's assets to its creditors. By contrast, in a receivership, the receiver is appointed by secured creditors to realize the secured assets and distribute the proceeds to satisfy the debts secured by the property. A receivership and a liquidation, however, can function in tandem.

Although the receiver represents the interests of secured creditors, the receiver has a duty to unsecured creditors to sell the assets for a fair price. Moreover, the liquidator has authority to review the appointment of the receiver and to monitor the progress of the receivership. The liquidator also investigates secured creditor claims and may challenge such claims and any liens securing them.

RCS argued that the Australian receivership, rather than the liquidation, was effectively recognized by the bankruptcy court and that the receivership was not a "collective proceeding" as required by section 101(23), because the receiver represents only the interests of secured creditors. Judge Scirica rejected this argument, explaining that ABC's *liquidation* proceeding was recognized by the court, and the fact that, in this particular case, the debtor's assets were fully leveraged did not affect the collective nature of the proceeding:

> Chapter 15 makes no exceptions when a debtor's assets are fully leveraged. Subject to the public policy exception, Chapter 15 recognition must be ordered when a court finds the requisite criteria are met, . . . replacing the Section 304 list of guiding principles. . . . We do not find any exception to recognition based on

> the debtor's debt to value ratio at the time of insolvency. Moreover, we find such an exception could contravene the stated purposes of Chapter 15 and the mandatory language of Chapter 15 recognition.

RCS also contended that the Australian liquidation should not be recognized because the benefits of recognition would inure solely to the receivership—a noncollective proceeding—and thus, recognition would contravene U.S. public policy favoring collective insolvency proceedings.

Judge Scirica explained that, given the express language of section 1506 (i.e., "*manifestly* contrary to the public policy of the United States") (emphasis added), chapter 15's public-policy exception has been narrowly construed. It applies only "where the procedural fairness of the foreign proceeding is in doubt or cannot be cured by the adoption of additional protections" or where recognition "would impinge severely a U.S. constitutional or statutory right" (internal quotation marks and citations omitted). Rather than contravene public policy, Judge Scirica concluded, recognition of the Australian liquidation "advances the policies that animate the collective proceeding requirement." According to the judge, RCS was attempting to attach assets before the secured creditors could realize on them. Absent chapter 15 recognition, he wrote, "RCS could skip ahead of the priorities of the secured creditors," an outcome that would "eviscerate the orderly liquidation proceeding, and ignores all priority of debts."

Judge Scirica was not convinced, moreover, that Australian insolvency rules conflict with U.S. bankruptcy law in any way that would warrant invocation of the public-policy exception. He explained that the sole difference is that Australian law "allows secured creditors to realize the full value of their debts, and tender the excess to the company, whereas secured creditors in the United States must generally turn over assets and seek distribution from the bankruptcy estate."

He wrote that Australian law, rather than manifestly contravening U.S. policy, "establishe[s] a different way to achieve similar goals." By contrast, allowing RCS to use U.S. courts to circumvent the Australian liquidation proceeding "would undermine the core bankruptcy policies of ordered proceedings and equal treatment."

Judge Scirica also rejected RCS's argument that the automatic stay should not prevent it from enforcing its state-court verdict against ABC's U.S. assets. Because the assets were fully encumbered, RCS claimed, they were not "property of the debtor . . . within the territorial jurisdiction of the United States," as required by section 1520(a) of the Bankruptcy Code. The judge concluded that, even though ABC's U.S. property was fully leveraged, ABC retained an equitable interest in the assets because, under Australian law: (i) the receiver was obligated to pay any excess remaining after realization by secured creditors to ABC; (ii) ABC had a right of redemption (i.e., by paying the secured creditor the value of its claim); and (iii) if the liquidator successfully challenged the validity of the liens encumbering the assets, ABC would be entitled to retain the property.

In this regard, Judge Scirica was skeptical about the relevance of section 541 of the Bankruptcy Code (defining "property of the estate") in defining "property of the debtor" protected by the automatic stay in a chapter 15 case. Even if it were relevant, Judge Scirica explained, section 541(d)—which excludes from the estate property in which the debtor holds only legal title and not any equitable interest—would not operate to place ABC's encumbered assets outside the realm of "property of the debtor" by reason of this retained equitable interest.

Finally, Judge Scirica emphasized that permitting RCS to end-run the Australian liquidation proceeding by levying on ABC's U.S. assets would undermine the very purpose of chapter 15:

> Allowing an unsecured creditor to recover a judgment under these circumstances would require a hodgepodge of United States and Australian bankruptcy law. This is one of the outcomes Chapter 15 was designed to prevent by recognizing foreign main proceedings in United States courts.

Outlook

ABC Learning illustrates the core principles of chapter 15 as a mechanism for promoting the efficient and expeditious administration of cross-border insolvency proceedings. Efforts by creditors to act outside the framework of rules erected by chapter 15 and the Model Law would undermine the entire system and the universalist (as distinguished from the territorial, or "grab rule") approach underpinning it.

The ruling also reaffirms the basic idea that foreign insolvency regimes need not be identical to U.S. bankruptcy laws as a prerequisite to recognition under chapter 15. Rather, recognition is warranted so long as: (i) the foreign proceeding meets the requirements imposed by chapter 15; and (ii) the rules and procedures governing the foreign proceeding promote goals similar to those expressed in U.S. bankruptcy laws and do not "manifestly" offend U.S. public policy.

Finally, *ABC Learning* highlights important differences between chapter 15 and its statutory predecessor, section 304. In keeping with the purposes of chapter 15 and the Model Law, recognition of a foreign bankruptcy or insolvency proceeding that satisfies the statutory criteria is mandatory.

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