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BANKRUPTCY COURT IN CHAPTER 15 CASE REFUSES TO EXTEND COMITY TO *GIBBS* RULE IN ENFORCING CROATIAN SETTLEMENT MODIFYING ENGLISH-LAW DEBT

Dan T. Moss ▪ Mark G. Douglas

For more than a century, courts in England and Wales have refused to recognize or enforce foreign court judgments or proceedings that discharge or compromise debts governed by English law. In accordance with a rule (the "*Gibbs* Rule") stated in an 1890 decision by the English Court of Appeal, creditors holding debt governed by English law may still sue to recover the full amount of their debts in England even if such debts have been discharged or modified in connection with a non-U.K. bankruptcy or insolvency proceeding.

Such territorialism flies in the face of the "modified universalist" framework governing cross-border insolvencies that has been sanctioned by the more than 40 countries, including the U.K. and the U.S., that have enacted some form of the 1997 UNCITRAL Model Law on Cross-Border Insolvency (the "CBI Model Law").

Judge Martin Glenn of the U.S. Bankruptcy Court for the Southern District of New York recently addressed this inconsistency in *In re Agrokor d.d.*, 591 B.R. 163 (Bankr. S.D.N.Y. 2018). Having previously entered an order recognizing a Croatian company's restructuring proceeding under chapter 15 of the Bankruptcy Code, the court recognized and enforced a settlement agreement that restructured English-law debt. It concluded that, under principles of comity, it would be appropriate to enforce the settlement agreement in the U.S., even though enforcement of the agreement would represent a refusal to extend comity to the *Gibbs* Rule.

COMITY

"Comity" is "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws." *Hilton v. Guyot*, 159 U.S. 113, 164 (1895). International comity has been interpreted to include two distinct doctrines: (i) "legislative," or "prescriptive," comity; and (ii) "adjudicative" comity. *Maxwell Comm'n Corp. v. Societe Generale (In re Maxwell Comm'n Corp.)*, 93 F.3d 1036, 1047 (2d Cir. 1996).

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The former "shorten[s] the reach of a statute"—one nation will normally "refrain from prescribing laws that govern activities connected with another state when the exercise of such jurisdiction is unreasonable." *Official Comm. of Unsecured Creditors of Arcapita Bank B.S.C.(c) v. Bahrain Islamic Bank (In re Arcapita Bank B.S.C.(c))*, 575 B.R. 229, 237 (Bankr. S.D.N.Y. 2017).

"Adjudicative" comity, or "comity among courts," is an act of deference whereby the court of one nation declines to exercise jurisdiction in a case that is properly adjudicated in a foreign court. *Id.* at 238. U.S. courts generally extend comity whenever a foreign court has proper jurisdiction and "enforcement does not prejudice the rights of United States citizens or violate domestic public policy." *CT Inv. Mgmt. Co., LLC v. Cozumel Caribe, S.A. de C.V. (In re Cozumel Caribe, S.A. de C.V.)*, 482 B.R. 96, 114 (Bankr. S.D.N.Y. 2012).

Because a foreign nation's interest in the equitable and orderly distribution of a foreign debtor's assets is an interest deserving respect and deference, U.S. courts generally defer to foreign bankruptcy proceedings and decline to adjudicate creditor claims that are the subject of such proceedings. *See Canada Southern Railway Co. v. Gebhard*, 109 U.S. 527, 548 (1883) ("the true spirit of international comity requires that [foreign schemes of arrangement], legalized at home, should be recognized in other countries"); *accord JP Morgan Chase Bank v. Altos Hornos de Mexico S.A. de C.V.*, 412 F.3d 418 (2d Cir. 2005) (applying principles of comity in an ancillary proceeding under section 304 of the Bankruptcy Code, the precursor to chapter 15 of the Bankruptcy Code); *In re Int'l Banking Corp. B.S.C.*, 439 B.R. 614, 624 (Bankr. S.D.N.Y. 2010) (citing cases).

In this context, deference to a foreign proceeding is warranted "so long as the foreign proceedings are procedurally fair and . . . do not contravene the laws or public policy of the United States." *Cozumel Caribe*, 482 B.R. at 114. Courts examine a number of factors in assessing procedural fairness, including:

> (1) whether creditors of the same class are treated equally in the distribution of assets; (2) whether the liquidators are considered fiduciaries and are held accountable to the court; (3) whether creditors have the right to submit claims which, if denied, can be submitted to a bankruptcy court for adjudication; (4) whether the liquidators are required to give notice to the debtor's potential claimants; (5) whether there are provisions for creditors meetings; (6) whether a foreign country's insolvency laws favor its own citizens; (7) whether all assets are marshalled before one body for centralized distribution; and (8) whether there are provisions for an automatic stay and for the lifting of such stays to facilitate the centralization of claims.

Finanz AG Zurich v. Banco Economico S.A., 192 F.3d 240, 249 (2d Cir. 1999).

ROLE OF COMITY IN CASES UNDER CHAPTER 15 OF THE BANKRUPTCY CODE

As with the CBI Model Law, comity is a pillar of chapter 15 of the Bankruptcy Code. *Cozumel Caribe*, 482 B.R. at 114–15 (a central tenet of chapter 15 is the importance of comity in cross-border insolvency proceedings).

Under section 1515 of the Bankruptcy Code, the representative of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." Section 101(24) of the Bankruptcy Code defines "foreign representative" 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 "foreign main proceeding"—a case pending in the country where the debtor's center of main interest (COMI) is located (*see* 11 U.S.C. § 1502(4))—and "foreign nonmain proceedings," which may have been commenced in countries where the debtor merely has an "establishment" (*see* 11 U.S.C. § 1502(5)).

Section 1509(b) provides that, if the U.S. bankruptcy court recognizes a foreign proceeding, the foreign representative may apply directly to another U.S. court for appropriate relief, and a U.S. court "shall grant comity or cooperation to the foreign representative."

In addition, after recognition of a foreign proceeding, section 1521(a) authorizes the court, upon the request of the foreign representative, to grant a broad range of relief designed to preserve the foreign debtor's assets or otherwise provide assistance to the court or other entity presiding over the debtor's foreign proceeding. Such post-recognition relief "is largely discretionary and turns on subjective factors that embody principles of comity." *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 329 B.R. 325, 333 (S.D.N.Y. 2008).

Section 1507 of the Bankruptcy Code similarly states that, post-recognition, the court may provide "additional assistance" to a foreign representative under the Bankruptcy Code "or under other laws of the United States." In determining whether to provide such relief, the court must consider whether such assistance, "consistent with the principles of comity," will reasonably ensure, among other things: (i) the just treatment of all creditors and interest holders; (ii) protection of U.S. creditors "against prejudice and inconvenience in the processing of claims in such foreign proceeding"; and (iii) "distribution of proceeds of the debtor's property substantially in accordance with the order prescribed" in the Bankruptcy Code.

Discretionary relief under sections 1507 and 1521 can include recognition and enforcement of a restructuring plan or scheme approved by a foreign court. *See In re Avanti Comm'ns Grp. PLC*, 582 B.R. 603 (Bankr. S.D.N.Y. 2018); *In re Rede Energia S.A.*, 515 B.R. 69 (Bankr. S.D.N.Y. 2014); *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010).

However, section 1522 provides that the bankruptcy court may grant relief under section 1521 "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."

In addition, section 1506 of the Bankruptcy Code sets forth a public policy exception to the relief otherwise authorized in chapter 15, providing 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."

THE *GIBBS* RULE AND THE NEW MODEL LAW ON THE ENFORCEMENT OF INSOLVENCY JUDGMENTS

In *Antony Gibbs & Sons v. La Société Industrielle et Commerciale des Métaux* [1890] LR 25 QBD 399, a Parisian company entered into a contract to purchase copper from a London merchant. Delivery of the copper was to take place in England. The buyer was placed into a judicial liquidation proceeding in France and refused to take delivery of some of the copper. The seller filed a claim in the liquidation proceeding for damages but reserved its right to continue prosecuting an action against the buyer in an English court. The French liquidator disallowed the claim for damages, and a French court upheld that determination. Thus, the claim was effectively discharged in the French liquidation proceeding.

In the pending English litigation, the Court of Appeal concluded that the contract was governed by English law and that discharge of the claim in the French liquidation proceeding did not prevent the seller from attempting to collect on it in England. The Court reasoned:

> Why should the plaintiffs be bound by the law of a country to which they do not belong, and by which they have not contracted to be bound? Therefore, if it were true that in any of the modes suggested the defendants were by the law of France discharged from liability, I should say that such law did not bind the plaintiffs, and that they were nevertheless entitled, according to English law, to maintain their action upon an English contract.

The *Gibbs* Rule has been applied in many subsequent U.K. court rulings, even after the U.K. adopted its version of the CBI Model Law in 2006 (the Cross-Border Insolvency Regulations (the "CBIR")). *See, e.g.*, *Bakhshiyeva v Sberbank of Russia* [2018] EWHC 59 (Ch) (ruling that, under the *Gibbs* Rule, the court would refuse to grant the application of the foreign representative of an Azerbaijan bank debtor for a permanent stay of creditors' enforcement of claims in England under an English law-governed contract, contrary to the terms of the bank's Azeri insolvency proceeding, even though the proceeding had been recognized in England under the CBIR), *aff'd*, [2018] EWCA Civ 2802, 2018 WL 06605589 (Dec. 18, 2018) (holding that the CBI Model Law is merely procedural and cannot impair substantive English-law contract rights protected by the *Gibbs* Rule); *accord Goldman Sachs International v Novo Banco SA* [2018] UKSC 34, [2018] 1 WLR 3683.

Because it is inconsistent with the modified universalist approach underpinning modern cross-border bankruptcy legislation, the *Gibbs* Rule has frequently been criticized as an anachronism that should be consigned to the dregs of history. *See, e.g.*, *Pacific Andes Resources Development Ltd.* [2016] SGHC 210 (discussing various academic criticisms of the *Gibbs* Rule's continued application and explaining that a fundamental problem with the rule in international insolvency cases is that it mischaracterizes the discharge of debt as a contractual issue rather than an issue of bankruptcy law, which gives primacy to policy over contractual rights).

On September 18, 2018, the United Nations Commission on International Trade Law published its final version of the new Model Law on the Recognition and Enforcement of Insolvency-Related Judgments (the "IRJ Model Law"). The IRJ Model Law creates a framework for the recognition and enforcement of judgments in foreign bankruptcy and insolvency proceedings. It is intended to supplement and complement the CBI Model Law. If adopted by the U.K., the IRJ Model Law would presumably abrogate the *Gibbs* Rule. Until then, however, it persists as an impediment to the enforcement of non-U.K. insolvency judgments impairing English-law contract rights.

In *Agrokor*, the U.S. bankruptcy court was confronted with a dilemma: under principles of comity, should it recognize and enforce a Croatian settlement agreement that restructured English-law debt, even though a U.K. court applying the *Gibbs* Rule would likely refuse to do so?

AGROKOR

The Agrokor Group ("AG") is the largest private company by revenue in the Republic of Croatia, with more than 60,000 employees. Seventy-seven AG companies are based in Croatia and established under Croatian law, but they operate both within and outside the country. These entities are part of a group of 155 AG companies, the remainder of which are not based in Croatia and operate outside the country (principally in Slovenia, Serbia, and Bosnia-Herzegovina).

AG's financial difficulties and its importance to the Croatian economy spurred the enactment in April 2017 of Croatia's Act on the Extraordinary Administrative Proceedings in Companies of Systemic Importance for the Republic of Croatia (the "EA Law"). As stated in its preamble, the purpose of the legislation, which does not apply solely to the Agrokor Group, is the "protection of sustainability of operations of the companies of systemic importance for the Republic of Croatia which with its operations individually or together with its controlled or affiliated companies affect the entire economic, social and financial stability of the Republic of Croatia." The law applies to enterprise groups of Croatian companies that have a principal place of business in Croatia, even though they may operate both within and outside the country.

The EA Law includes provisions for the reorganization and adjustment of debts of systemically important companies. Those provisions contemplate the negotiation, acceptance by creditors, and court approval of a settlement agreement—essentially a plan of reorganization that adjusts the debt and ownership interests of distressed companies.

The 77 Croatia-based AG companies (the "AG Debtors") commenced a proceeding under the EA Law (the "EA Proceeding") shortly after it was enacted in April 2017. At the time of the filing, these companies had approximately €625 million in New York law-governed debt and €1.6 billion in English law-governed debt.

The settlement agreement proposed in the EA Proceeding (the "Settlement Agreement") classified and treated various categories of priority, unsecured, and secured claims, as well as equity interests. The agreement provided for a projected recovery of not more than 51 percent on the English and New York law-governed debt and incorporated certain third-party releases, including releases of guarantees of the English and New York law-governed debt.

On July 4, 2018, the required majority of AG's creditors (including insider creditors) voted to accept the Settlement Agreement, which was later approved by the Commercial Court of Zagreb in Croatia. The High Commercial Court denied more than 90 appeals of the approval order on October 26, 2018, making the Settlement Agreement final.

In 2017 and 2018, the foreign representative of the AG Debtors sought recognition of the EA Proceeding in seven foreign jurisdictions, including the U.K. and the U.S. As of November 2018, only a Swiss court had issued a final decision recognizing the proceeding under its insolvency law. In September 2017, the High Court of England and Wales had recognized the EA Proceeding under the CBIR, finding that the proceeding did not manifestly violate English public policy. However, that decision is on appeal and did not include recognition of the Settlement Agreement, which was approved by the Croatian court after the English court entered its recognition order.

Courts in Slovenia, Serbia, Bosnia-Herzegovina, and Montenegro refused to recognize the EA Proceeding, although those rulings have also been appealed. Among other things, those courts expressed concern that the EA Law was enacted not for the collective benefit of creditors, but on an ad hoc basis to benefit AG and to protect the economic, social, and financial stability of Croatia.

In July 2018, the Recast Insolvency Regulation (EU) 2015/848 became effective in the European Union. Thus, enactment of the EA Law by Croatia ostensibly afforded the EA Proceeding automatic recognition as an insolvency proceeding in all European Union member states.

On July 12, 2018, the foreign representative filed a petition on behalf of nine AG Debtors in the U.S. Bankruptcy Court for the Southern District of New York, seeking recognition of the EA Proceeding under chapter 15 as well as recognition and enforcement of the Settlement Agreement in the U.S. The bankruptcy court entered an order recognizing the EA Proceeding on September 21, 2018. However, the court reserved decision at that time on the request to recognize and enforce the Settlement Agreement.

THE BANKRUPTCY COURT'S RULING

On October 24, 2018, the bankruptcy court issued an order provisionally recognizing and enforcing the Settlement Agreement, subject to its finalization.

The court began its analysis by examining various aspects of the EA Law in an effort to determine whether its rules are procedurally fair in accordance with the factors stated in *Finanz AG Zurich*. The court noted, among other things, that under the EA Law: (i) a proceeding is presided over by a Croatian court; (ii) the debtor is represented by a court-appointed "extraordinary commissioner" with the statutory duties of a bankruptcy receiver; (iii) creditors are represented in the proceeding by a creditors' committee; (iv) procedures exist for notice to creditors of the proceedings and the resolution of creditor claims; (v) procedures are provided for the negotiation, acceptance by creditors, and court approval of a settlement agreement providing for the treatment of claims and interests; (vi) creditors are deemed to accept a settlement agreement if the requisite majority of creditors vote in favor of it; and (vii) all creditors are bound by a settlement agreement, whether or not they vote.

Concluding that the EA Law "tracks closely to the structure" of the U.S. Bankruptcy Code and many other foreign insolvency laws, the court accordingly held that the EA Proceeding "was procedurally fair, provided proper notice to all creditors and, through the Settlement Agreement, determined the rights of all creditors to property that was subject to the jurisdiction of the Croatian Court."

Having concluded that the EA Law's structure is procedurally fair—a finding that it had previously made in granting the petition for recognition of the EA Proceeding—the bankruptcy court next examined whether there was any reason that it should refuse to recognize and enforce the Settlement Agreement in the U.S. It found none, on the basis of the terms of the Settlement Agreement itself, notwithstanding the fact that several other courts had refused to recognize the EA Proceeding or the possibility that the English courts might refuse to recognize the Settlement Agreement in whole or in part under the *Gibbs* Rule.

The court explained that, although the Settlement Agreement released and discharged guarantees by nondebtor affiliates of both the English law and New York law-governed debt, "this Court has recognized and enforced such releases" under appropriate circumstances (citing *Avanti*, 582 B.R. at 617–18, and *Metcalfe & Mansfield*, 421 B.R. at 688).

Nor was the court troubled that votes cast by "insiders" might have tainted acceptance of the Settlement Agreement. It explained that, in *In re Vitro S.A.B. de C.V.*, 701 F.3d 1031 (5th Cir. 2012), the Fifth Circuit affirmed a bankruptcy court's refusal in a chapter 15 case to recognize a Mexican court's order approving a Mexican debtor's reorganization plan containing guarantor releases because acceptance of the plan was possible only by counting the votes of insiders, which is contrary to U.S. bankruptcy law (*see* 11 U.S.C. § 1129(a)(10)). Unlike in *Vitro*, the *Agrokor* court noted, the requisite majority of creditors accepted the Settlement Agreement without counting insider votes.

Given the procedural fairness of the EA Law, its previous recognition of the EA Proceeding, the terms of the Settlement Agreement (including the fact that creditor distributions "closely follow the waterfall provisions of the U.S. Bankruptcy Code"), and the agreement's overwhelming acceptance by creditors, the court concluded that the Settlement Agreement, including the third-party releases, should be "recognized and enforced in these Chapter 15 cases with respect to the nine Foreign Debtors that filed these Chapter 15 cases." Under the circumstances, the court emphasized, its broad discretion to grant post-recognition relief under sections 1507 and 1521 encompasses recognition and enforcement of the Settlement Agreement.

Decisions of other foreign courts denying recognition of the EA Proceeding, the bankruptcy court wrote, "have no direct impact upon the decision to recognize and enforce the [EA] Proceeding and Settlement Agreement in the U.S."

Finally, the court concluded that the *Gibbs* Rule was not an impediment to recognition and enforcement of the Settlement Agreement in the U.S. The court agreed with other foreign courts and commentators that the *Gibbs* Rule mischaracterizes the discharge of debt in international insolvency cases as a contractual issue rather than as a bankruptcy or insolvency-law issue. The court noted that "England, of course, is free to continue to adhere to the *Gibbs* rule, but that does not mean that a U.S. bankruptcy court must follow the rule in deciding whether to recognize and enforce the decision of a court of another jurisdiction."

As noted, the Settlement Agreement became final on October 26, 2018. The bankruptcy court entered an order unprovisionally recognizing and enforcing the agreement on December 14, 2018.

OUTLOOK

Cases like *Agrokor* are emblematic of the increasing incidence of cross-border bankruptcy cases involving enterprise groups of companies based or operating in, or having debt instruments governed by, multiple countries. Many nations have recently enacted legislation designed to address the proliferation of such cases, which sometimes present difficult issues that may not be adequately addressed by existing cross-border bankruptcy laws, including the CBI Model Law and chapter 15. In *Agrokor*, because each of the debtors involved in the case had a common COMI in Croatia, the court concluded that, although the enterprise group aspects of the EA Law were "novel," the chapter 15 cases "do not push the boundaries of cross-border insolvency law."

The *Gibbs* Rule is a throwback to the older era of territorialism, during which the courts and laws of individual countries protected the interest of local creditors. The CBI Model Law, chapter 15, and the IRJ Model Law embrace a more universalist approach. Subject to certain exceptions—such as the "public policy" exception—this approach embraces the extension of comity to foreign bankruptcy regimes, even if they are not identical to the regime of the recognizing court's country, so long as foreign proceedings are procedurally fair.

Comity is a central element of chapter 15. If a U.S. bankruptcy court determines that a foreign proceeding meets the requirements for recognition under chapter 15, that court and other U.S. courts are obligated to extend comity to the foreign representative. Moreover, as illustrated in *Agrokor*, the bankruptcy court has broad discretion to grant appropriate post-recognition relief, including the recognition and enforcement of a foreign debtor's restructuring plan.

Finally, in recognizing and enforcing in the U.S. an agreement modifying or discharging English law-governed debt, regardless of whether U.K. courts ultimately determine to do so in the U.K., the U.S. bankruptcy court's ruling in *Agrokor* may be viewed as a further evolution of chapter 15 precedent applying international comity.

SECURED LENDERS' INTEREST DOES NOT REACH REORGANIZED EQUITY

Corinne Ball

In *In re MPM Silicones, LLC*, the U.S. District Court for the Southern District of New York recently affirmed a 2014 opinion by the U.S. Bankruptcy Court for the Southern District of New York in an intercreditor dispute that may impact the frequency and efficacy of cramdown in future contested plan confirmations under chapter 11 of the Bankruptcy Code. 518 B.R. 740 (Bankr. S.D.N.Y. 2014), *aff'd*, No. 15-2280 (NSR), 2019 WL 121003 (S.D.N.Y. January 4, 2019) ("*Momentive*"). Where the secured lenders' liens are continued under a chapter 11 plan providing the secured lender with a stream of payments having a present value equal to the value of the lenders' collateral, the district court ruled that the secured lenders' lien does not extend to the reorganized equity issued under the chapter 11 plan.

BACKGROUND

Momentive's first- and second-lien creditors were parties to an intercreditor agreement that prohibited the exercise of any remedies by the second-lien creditors with respect to the common collateral and its proceeds until the first-lien creditors were paid in full. The debtors' plan of reorganization, which was confirmed over the dissent of the first-lien creditors (the "Seniors"), provided the first-lien creditors with replacement notes and reinstated their liens on the collateral. The plan provided the equity issued by the reorganized debtor to the second-lien creditors (the "Seconds") in discharge of their claims. The Seconds supported the plan by voting in favor of it, joining a restructuring support agreement, and agreeing to backstop a rights offering by the reorganized debtor, raising new capital.

Although the Seniors voted against the plan, the plan was confirmed on a "cramdown" basis with the support of the Seconds. The decision confirming the plan was affirmed on appeal. The Seniors brought suit against the Seconds for breach of the intercreditor agreement. The bankruptcy court dismissed the action against the Seconds and was again affirmed on appeal.

THE OPINIONS

The Seniors' suit alleged violations of the intercreditor agreement due to the Seconds entering into a restructuring agreement and supporting a "cramdown" plan, as well as accepting fees in exchange for providing a backstop and accepting the reorganized equity before the Seniors were paid in full.

On appeal, the district court addressed many of the arguments unsuccessfully raised by the Seniors before the bankruptcy court. First, the courts examined what rights are conferred or proscribed by the intercreditor agreement, also considering the implied covenant of good faith and fair dealing. Second, and most importantly, both courts considered whether common stock in the reorganized entity constitutes "proceeds of collateral." The majority of the issues raised by the Seniors were addressed as matters of contract interpretation and existing precedent regarding the extent of the waiver of rights by the Seconds in favor of the Seniors. In contrast, the allegation that the Seconds breached the intercreditor agreement in supporting a cramdown plan opposed by the Seniors was resolved by the bankruptcy court through an analysis of the fundamental responsibilities of a chapter 11 debtor. This conclusion, as well as what is perhaps the most controversial determination that the Seniors' liens did not extend to the stock of the reorganized debtor as proceeds of collateral, were affirmed.

Does supporting a cramdown plan breach the intercreditor agreement?

The bankruptcy court addressed whether the Seconds, in supporting a plan that provided for the confirmation of a plan over the objection of the Seniors on a cramdown basis, breached the Seconds' obligation to refrain from interfering with the Seniors' exercise of remedies against the common collateral. The bankruptcy court recognized that the plan impacted the exercise of remedies by the Seniors, but also observed that the cramdown plan was presented and prosecuted by the debtor, not the Seconds. While the Seniors pointed to the restructuring support agreement as a prohibited interference with the Seniors' exercise of remedies, the bankruptcy court reasoned that the Seconds' actions in support of the plan should be viewed as holding the debtor to an appropriate discharge of its fiduciary duties to unsecured creditors to assure that the Seniors were not overpaid and the rights of unsecured creditors (including the Seconds' unsecured deficiency claim) were protected. Under that analysis the Seconds' action in entering into the restructuring support agreement was not subject to the intercreditor agreement.

Does the equity of the reorganized debtor constitute "proceeds" of collateral?

The intercreditor agreement prohibited the Seconds from receiving proceeds of the common collateral before the Seniors were paid in full. Accordingly, the Seniors argued that the Seconds, in accepting the common stock of the reorganized debtor under the chapter 11 plan, breached the intercreditor agreement because the common stock of the reorganized debtor constituted proceeds of the common collateral.

The bankruptcy court's opinion

Judge Drain rejected this argument by holding that common stock of the reorganized debtor did not constitute "proceeds of collateral." The Seniors argued that such common stock amounted to "proceeds of collateral" because it was given to the Seconds "on account of" the collateral (or a portion of the collateral, because most of the Seconds' claims were unsecured deficiency claims), or the distribution was in respect of "rights arising out of" the collateral. The bankruptcy court observed that the Seconds were the "fulcrum" security, meaning that the claims of the Seconds exceeded the value of the common collateral, thus leaving the Seconds with a large deficiency or unsecured claim. Significantly, the intercreditor agreement focused on the rights of the Seniors and Seconds in collateral and proceeds of collateral. The intercreditor agreement did not have a definition of "proceeds," so the court's analysis turned to the definition under the Uniform Commercial Code as implemented in New York.

The bankruptcy court held that common stock did not amount to "proceeds" for a host of reasons. First, the bankruptcy court found that the Seniors' liens and claims against the debtor did not extend to the common stock because the common stock was a distribution on account of the Seconds' largely unsecured claims. The Seniors did not have a lien on the claims of the Seconds and thus were not entitled to claim that the Seniors' security interest extended to the distribution on account of the largely unsecured claim of the Seconds. Next, the bankruptcy court determined that the plan left the collateral and the Seniors' liens on that collateral totally unchanged. Taking an alternative definition of "proceeds," the bankruptcy court looked for whether the collateral had been transformed, damaged, consumed or exhausted, or, in other words, changed at all. It found that the property constituting the collateral remained the same, that no characteristic of the collateral was changed by the distribution of the stock, and that the collateral was in no way diminished by the issuance of such stock. In short, because there was no change in the collateral, the bankruptcy court concluded that the common stock did not amount to "proceeds."

The district court's opinion

In affirming the bankruptcy court, the district court adopted the bankruptcy court's reasoning that the distribution of common stock was on account of the Seconds' largely unsecured claims and that the Seniors did not have a lien on the claims of the Seconds. In addition, the district court also concluded that the common stock of the reorganized debtor is not "proceeds of collateral." The district court read the definition under New York's Uniform Commercial Code and found that the essential characteristics of "proceeds" are that they have to do with an action that exhausted, decreased, diluted, or otherwise used up the collateral.

In their appeal to the district court, the Seniors invoked another provision of the intercreditor agreement that gave the Seniors the exclusive power to enforce rights, exercise remedies and make determinations regarding the release, disposition or restrictions with respect to the collateral. The Seniors argued that this provision precluded the Seconds from acting on their unsecured claims, essentially equating the intercreditor agreement with a waiver by the Seconds of any deficiency claim and thus providing the Seniors with control over the liens and claims of the Seconds. The district court dismissed this argument as a "weak attempt at [a] shell game," stating that "[it] cannot nullify foundational provisions of the Bankruptcy Code to prop an illogical reading of the [intercreditor agreement]." The district court found "it clear beyond a doubt that proceeds was never intended to—and as a matter of economics cannot—refer to the reorganized common stock that the Seconds received in lieu of giving up their liens to the Common Collateral and restructuring their swath of unsecured debt."

CONCLUSION AND TAKEAWAYS

The legacy of *Momentive* should provide sorely needed guidance to the distressed investing community. The *Momentive* decisions are important not only for the most recognized issue of considering the market rate in assessing the rate of interest payable in a cramdown plan, but also for their significant guidance on the importance of contracts and their interplay with the Bankruptcy Code. There is a fundamental tension between achieving a "silent second" lien and maintaining rights as an unsecured creditor. Hence it is important to focus on the extent of waiver of rights by the junior lienors. Many of the issues raised and ultimately lost by the Seniors could be resolved by careful drafting, although with certain exceptions. For instance, it is not clear that the waiver sought from the holders of a silent second lien can function as a grant of a security interest in the claims of the junior lienor. Perhaps subordination of claims might yield a different result.

In addition, this decision is significant because it navigates from the important position held by the "fulcrum" security, and serves as a reminder of the fundamental precepts of the Bankruptcy Code. First, the debtor in possession has fiduciary duties which, by definition, reside outside a prepetition intercreditor contract. Secondly, it raises as a continuing question: What is the extent of a prepetition lien? The construction of proceeds as a concept that must derive from a change or diminution in collateral sets limits on the rights of secured lenders, yet respects their entitlement to the value of their collateral. Such rationale also arguably stakes out a position on whether secured lenders are entitled to reorganization value, another hotly debated topic among bankruptcy scholars and practitioners.

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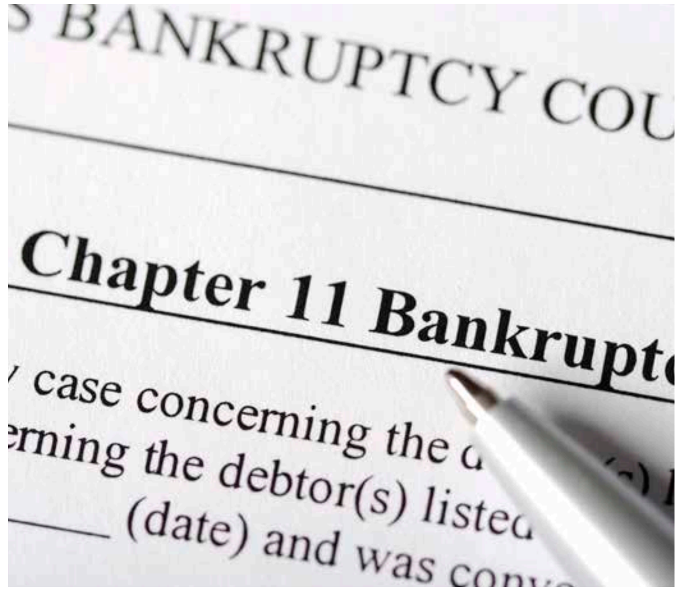


SUBORDINATION AGREEMENT BARRED BANKRUPTCY DISCOVERY CONCERNING SENIOR DEBT

Timothy Hoffmann ■ Mark G. Douglas

In *In re Argon Credit, LLC*, 2019 WL 169315 (Bankr. N.D. Ill. Jan. 10, 2019), the U.S. Bankruptcy Court for the Northern District of Illinois ruled that, in accordance with section 510(a) of the Bankruptcy Code, a standby clause in a subordination agreement prevented a subordinated lender from conducting discovery concerning the senior lender's claims. According to the court, the subordinated lender's efforts to circumvent the clear terms of the subordination agreement by claiming that it was acting on behalf of the bankruptcy estate, or investigating the senior lender's alleged fraud, were unavailing.

ENFORCEABILITY OF SUBORDINATION AGREEMENTS IN BANKRUPTCY

If the claims of one creditor or group of creditors are subordinated in accordance with the provisions of a valid and enforceable agreement, section 510(a) of the Bankruptcy Code provides that the subordination agreement is enforceable in a bankruptcy case to the same extent that it would be enforceable under applicable nonbankruptcy law.

In construing the validity, enforceability, and application of a subordination agreement, section 510(a) directs the bankruptcy court to look to applicable nonbankruptcy law—generally state law—as well as the terms of the agreement itself. *See* COLLIER ON BANKRUPTCY ¶ 510.03 (16th ed. 2019). If there is ambiguity in the agreement concerning the terms or extent of the subordination, a bankruptcy court may refuse to enforce it. *See In re Bank of New England Corp.*, 364 F.3d 355, 367 (1st Cir. 2004) (remanding the case to the bankruptcy court to determine under

New York law whether the subordination agreement actually provided for payment of postpetition interest on the senior debt prior to any payment on the junior debt), *on remand*, 404 B.R. 17 (Bankr. D. Mass. 2009) (finding that the parties did not intend to subordinate claims for postpetition interest), *aff'd*, 426 B.R. 1 (D. Mass. 2010), *aff'd*, 646 F.3d 90 (1st Cir. 2011).

Moreover, a chapter 11 plan need not necessarily give effect to the explicit terms of a subordination agreement in providing for the treatment of creditor claims. *See In re Tribune Media Co.*, 587 B.R. 606, 614 (D. Del. 2018) (because section 510(a) is expressly excepted from section 1129(b)(1) of the Bankruptcy Code, a non-consensual chapter 11 plan that does not fully enforce a subordination agreement may be confirmed so long as "the plan does not discriminate unfairly, and is fair and equitable").

ARGON CREDIT

Argon Credit, LLC, and Argon X, LLC (collectively, "Argon") operated an online lending platform providing near-prime consumer installment loans. To fund its operations, Argon borrowed $20 million in 2015 under a senior secured revolving credit facility. The debt was subsequently assigned to another lender (the "Senior Lender"), which subsequently increased the funds available under the revolving facility to $37.5 million (the "Senior Debt").

Certain Argon equity holders (collectively, the "Junior Lender") also made loans to Argon in 2015 (the "Junior Debt") on a subordinated basis. The subordination agreement and certain subsequent subordination agreements (collectively, the "subordination agreement") entered into by the Junior Lender and the Senior Lender provided for a "standby limitation" as follows:

> Notwithstanding any breach of default by [Argon] . . . under the [Junior Debt agreement], the [Junior Lender] shall not at any time or in any manner foreclose upon, take possession of, or attempt to realize on any Collateral, or proceed in any way to enforce any claims it has or may have against [Argon] or any other Obligor unless and until the Obligations to the Senior Lender have been fully and indefeasibly paid and satisfied in full.

In 2016, Argon filed a chapter 11 case in the Northern District of Illinois. After converting the case to a chapter 7 liquidation, the bankruptcy court approved a stipulation (the "discovery stipulation") between the chapter 7 trustee and the Senior Lender coordinating discovery by the trustee and all "parties in interest" under Rule 2004 of the Federal Rules of Bankruptcy Procedure regarding the enforceability of the Senior Debt. In accordance with the stipulation, all discovery requests were initiated in the first instance by the trustee, unless a party in interest conferred in good faith with the trustee concerning requested discovery and the trustee elected not to pursue the request, in which case the party seeking discovery could request it directly without filing a separate motion for court approval under Bankruptcy Rule 2004.

The trustee sought discovery from the Senior Lender of various documents related to the Senior Debt. The Senior Lender moved to quash the subpoena. The Junior Lender objected and (with the trustee's approval) sought an order from the bankruptcy court enforcing the subpoena.

The Senior Lender argued that the standby clause in the subordination agreement precluded the Junior Lender from seeking the requested discovery. The Junior Lender countered, among other things, that the subordination agreement did not bar it from obtaining discovery: (i) on behalf of the trustee and/or the estate; or (ii) regarding the Senior Lender's alleged fraud in inducing Argon to incur the Senior Debt.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court found that the standby clause in the subordination agreement was "an explicit and express 'silent seconds' provision aimed at preventing 'obstructionist behavior' [and] it [went] above and beyond the mere maintenance of the 'hierarchy of lien priorities' " in a subordination agreement (citing *In re MPM Silicones, L.L.C.*, 2019 WL 121003, at *11 (S.D.N.Y. Jan. 4, 2019)). According to the court, the clause prevented the Junior Lender "from using the bankruptcy process to affirmatively obtain discovery" from the Senior Lender regarding the Senior Debt.

Specifically, the court ruled that the Junior Lender could rely on neither the discovery stipulation nor Bankruptcy Rule 2004 to obtain discovery against the Senior Lender. The plain text of the subordination agreement, the court wrote, prevents the Junior Lender "from proceed[ing] in any way to enforce any claims" against the Senior Lender. According to the court, any act by the Junior Lender to obtain discovery concerning the Senior Debt "is a calculated, if intermediate, act to enforce" its claims against Argon. "It simply cannot be assumed," the court wrote, "that [the Junior Lender] is asking for discovery for no reason; [it] cannot be presumed [to be] irrational."

The bankruptcy court rejected the Junior Lender's argument that it was seeking discovery on behalf of the estate with the trustee's consent. Although the Junior Lender did coordinate its discovery requests with the trustee, the court explained, the trustee informed the Junior Lender that the estate could not afford to press forward with discovery demands after the Senior Lender refused the trustee's initial request for documents but did not oppose the Junior Lender's efforts to pursue further discovery. Nor did the trustee request that the Junior Lender perform duties on behalf of the trustee or the estate.

The court also rejected the Junior Lender's argument that the discovery stipulation somehow amended or waived the standby clause. According to the court, there was no clear indication that the Senior Lender, by entering into the discovery stipulation, either: (i) assented to a modification or amendment of the subordination agreement; or (ii) intentionally relinquished its rights under the subordination agreement, which generally benefited many parties in interest, not merely the Junior Lender.

Finally, the bankruptcy court was unpersuaded by the Junior Lender's argument that it should be allowed to investigate whether the Senior Lender fraudulently induced Argon to enter into the secured credit facility and the related subordination agreement by promising a $75 million line of credit that the Senior Lender never intended to provide. According to the court, Delaware law (which governed) does not permit nonenforcement of a bargained-for agreement between sophisticated commercial actors whenever one party claims that fraud has occurred. In addition, although a subordination agreement may be rescinded under certain circumstances as a remedy under Delaware law, the Junior Lender was not seeking rescission in this case. Thus, the subordination agreement would be enforced in Argon's bankruptcy case until a court ruled otherwise in an appropriate proceeding. In such a proceeding, the court wrote, the Junior Lender might be entitled to discovery from the Senior Lender "under the ordinary civil rules."

OUTLOOK

The court's ruling in *Argon Credit* indicates that, absent ambiguity or some other infirmity in a subordination agreement, a bankruptcy court will enforce the agreement in accordance with section 510(a) of the Bankruptcy Code. The bankruptcy court in *Argon Credit* foreclosed the Junior Lender from performing what the court perceived to be an end run around the express terms of the subordination agreement. As noted, however, the court did not rule out the possibility that the Junior Lender could obtain discovery in separate litigation over the enforceability of the subordination agreement.

Interestingly, in a footnote, the bankruptcy court noted that the Junior Lender's equity interest in Argon did not confer "party in interest" status on the Junior Lender independently of its claim based upon the Junior Debt because it had "no 'legally protected interest' based on the equity interest[] alone absent a showing of a possibility of a surplus estate" (citation omitted). Moreover, because the Junior Lender did not raise the argument, the court declined to consider whether its status as an equity interest holder made it a party in interest for purposes of the discovery stipulation. Had Argon's case not been converted to chapter 7 or had the estate had a surplus, this might have been a more significant issue. *See* 11 U.S.C. § 1109(b) (defining "party in interest" in a chapter 11 case to include "an equity security holder").

PROPOSED UNCITRAL MODEL LAW ON ENTERPRISE GROUP INSOLVENCY

In December 2018, at its 54th session in Vienna, Working Group V (Insolvency Law) of the United Nations Commission on International Trade Law (UNCITRAL) discussed revisions to its Enterprise Group Insolvency: Draft Model Law (the "EGI Model Law") as well as the EGI Model Law's Guide to Enactment.

The EGI Model Law is intended to govern the conduct and administration of insolvency proceedings involving enterprise group members that may be pending in several different countries. It is designed to complement the Model Law on Cross-Border Insolvency (the "CBI Model Law"), which has now been adopted in some form by 44 nations or territories, including the U.S., in chapter 15 of the Bankruptcy Code (enacted in 2005). The CBI Model Law establishes a framework for cooperation and coordination among courts presiding over cross-border bankruptcy and insolvency proceedings. The draft EGI Model Law and the CBI Model Law adopt the same format (in terms of structure and terminology) as the new Model Law on the Recognition and Enforcement of Insolvency-Related Judgments (the "IRJ

Model Law"), which UNCITRAL published in its final version on September 18, 2018.

Unlike the CBI Model Law, the EGI Model Law focuses more on multiple insolvency proceedings involving multiple debtors that are members of the same enterprise group, rather than cross-border proceedings involving a single debtor.

The topics discussed by the Working Group included:

- The term "group insolvency solution," which can include the reorganization or sale as a going concern of the whole or part of the business assets of one or more of the enterprise group members.
- The term "planning proceeding," by means of which a group insolvency solution is to be developed, coordinated, and implemented. Planning proceedings may be pending in more than one country, and the courts of one country may "recognize" a foreign planning proceeding in much the same way that courts may recognize foreign main and foreign nonmain proceedings under the CBI Model Law. A planning proceeding is a procedure whereby a representative for the member group companies will be appointed to oversee the formulation and implementation of an insolvency plan (i.e., a rescue procedure or restructuring plan) subject to court approval. Such a plan need not have unanimous creditor consent to be implemented.
- Forms of relief that may be available either after a court recognizes a foreign planning proceeding or at the time an application for recognition is filed, including: (i) injunctive relief to preserve an enterprise group member's assets; (ii) discovery; (iii) financing of group member operations; and (iv) additional relief that may be available to a duly appointed liquidator or administrator.

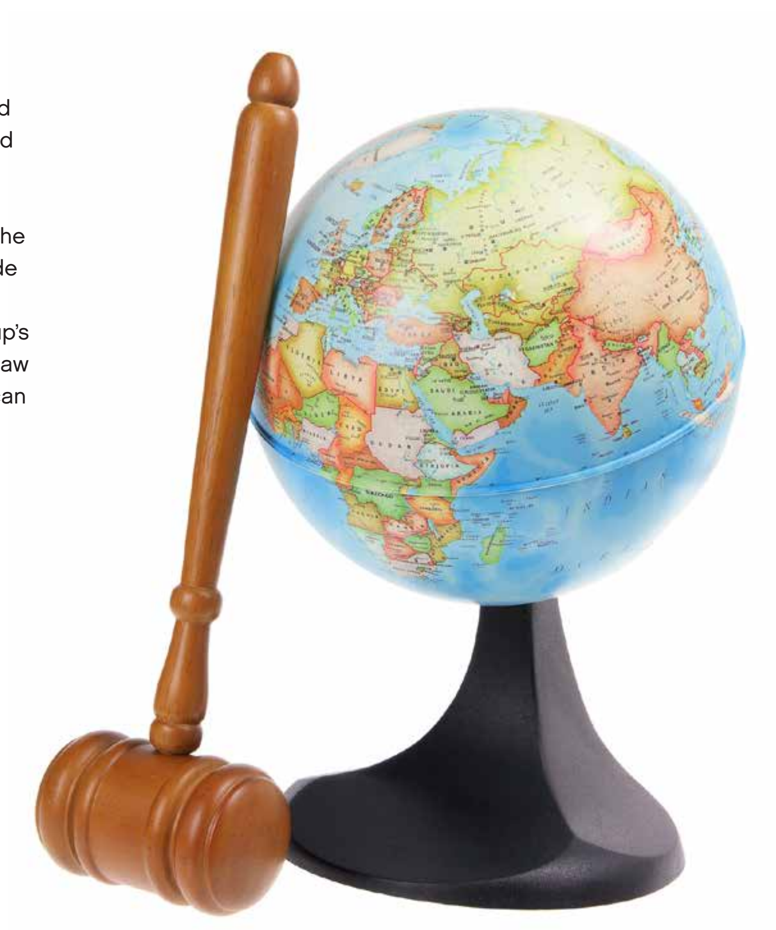
At the December 2018 meeting, the Working Group approved the substance of the draft EGI Model Law as well as the draft Guide to Enactment. Additional discussions concerning the draft law and guide will take place in May 2019 during the Working Group's 55th session in New York City. The final text of the EGI Model Law is expected to be published at the end of 2019, after which it can be implemented.

INTERNATIONAL LEGISLATIVE UPDATE: ITALIAN BANKRUPTCY REFORMS

On January 10, 2019, the Italian government approved the Code for Distress and Insolvency (*Codice della Crisi d'Impresa e dell'Insolvenza*—the "CDI") as part of Legislative Decree No. 14 of 2019, to replace the Italian Bankruptcy Law of 1942. With certain exceptions, the CDI will enter into force on August 14, 2020, unless amended by the Italian Parliament prior to the effective date.

The CDI does not supersede the rules applying to the insolvency of large companies (depending on the law involved, generally enterprises with more than either 200 or 500 employees, with at least €300 million in debt), which are subject to "extraordinary administration" in accordance with: (i) the "Prodi-bis law" enacted in the wake of the 1970s industrial crisis and amended in 1999 to be compatible with European law; and (ii) the "Marzano law," which was enacted in 2003 to address some of the inadequacies of the Prodi-bis law.

For companies not subject to extraordinary administration, the principal purpose of the CDI is to establish "safeguard procedures" for identifying financially distressed businesses at the earliest opportunity, with the goal of preventing insolvency and liquidation (*fallimenti*), and, in cases where insolvency cannot be



avoided, to promote renewed profitability by means of restructuring and reorganization. In service of that goal, the CDI, among other things:

- Limits the use of judicial compositions with creditors (*concordato preventivo*) to going-concern restructurings, as distinguished from liquidations;
- Puts in place measures to ensure that companies implement organizational structures designed to identify and remedy financial crises at the earliest opportunity;
- Modifies existing rules governing out-of-court and in-court restructurings and insolvencies to establish a consistent set of procedures applicable to all restructuring and insolvency mechanisms;
- Changes certain rules governing the obligations of company directors to disclose financial distress and to appoint a board of statutory auditors and provides incentives for taking prompt action to remedy a crisis;
- Simplifies court proceedings by, among other things, implementing online procedures for creditors to approve a *concordato preventivo*;
- Makes it easier to bind dissenting creditors to the terms of debt restructuring agreements by means of "cramdown";
- Reformulates several provisions governing the ability of a corporate debtor to obtain new financing during a restructuring;
- Amends existing procedures and introduces new ones for governing and coordinating group company insolvency proceedings, standstill agreements with nonfinancial creditors, and early-warning mechanisms; and
- Attempts to harmonize Italian insolvency procedures with the Recast Insolvency Regulation (EU) 2015/848, which became effective in the European Union in July 2018.

NEWSWORTHY

Jones Day ranked No. 1 in the 2019 Acritas U.S. Law Firm Brand Index, a report ranking the top law firm brands in the United States. This is the third consecutive year that Jones Day earned the top spot. According to Acritas, the brand index is "a reflection of which firms are uppermost in clients' minds, whom they are most attracted to and [to] whom they are most likely to give their work."

Roger Dobson (Sydney) was named a "Leading Lawyer" in the field of "Restructuring and insolvency" in *The Legal 500 Asia Pacific* 2019.

Heather Lennox (Cleveland and New York), ***Ben Larkin (London)***, ***Bruce Bennett (Los Angeles and New York)***, and ***Corinne Ball (New York)*** have been recommended as "Leaders in Their Field" in the area of "Restructuring/Insolvency" or "Bankruptcy/Restructuring" by *Chambers Global* 2019.

Paul M. Green (Houston) has been named a "Texas Rising Star" for 2019 in the field of "Bankruptcy: Business" by *Super Lawyers*.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "The Year in Bankruptcy: 2018" appeared in the March 2019 edition of the *INSOL International News Update*.

Jasper Berkenbosch (Amsterdam), ***Juan Ferré (Madrid)***, and ***Ben Larkin (London)*** were recognized in the field of "Restructuring/Insolvency" by *Chambers Europe* 2019.

BUSINESS RESTRUCTURING REVIEW

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Executive Editor: Charles M. Oellermann
Managing Editor: Mark G. Douglas

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