International Secured Transactions and Insolvency

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Section I of this article addresses a judicial opinion of note rendered during the reviewing period by the U.S. District Court for the Southern District of New York. Section II addresses developments in insolvency law in the United Kingdom and Brazil.

I. Recent Decisions: The Southern District of New York Affirms the Bankruptcy Court's Decision in *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*

In *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.* [hereinafter *Bear Stearns II*], the U.S. District Court for the Southern District of New York affirmed the bankruptcy court's decision to deny a request of foreign debtors for recognition of the earlier proceedings in the Cayman Islands as either foreign nonmain proceedings or foreign main proceedings.[2] In the underlying case, the bankruptcy court held that there was sufficient evidence to rebut the statutory presumption that the entities' center of main interests (COMI) was their place of registration in determining whether the entities were eligible for relief under Chapter 15 of the Bankruptcy Code as a main or nonmain foreign proceeding.[3]

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2. *See In re* Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 389 B.R. 325 (S.D.N.Y. 2008) [hereinafter *Bear Stearns II*].

3. *See In re* Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 374 B.R. 122, 127-28 (Bankr. S.D.N.Y. 2007) [hereinafter *Bear Stearns I*] (noting the "[statutory] presumption that the place of the registered office is also the [COMI] . . ."); *see also id.* at 132 (concluding that the Cayman Proceedings were not eligible for "relief as main or nonmain proceedings under chapter 15.").

In the *Bear Stearns II* decision, the court considered the claims of foreign representatives (Representatives) of two Bear Stearns' funds (Funds), which sought recognition by the bankruptcy court of the liquidation proceedings commenced in the Cayman Islands (Cayman Proceedings) involving the Funds as either foreign main proceedings or foreign nonmain proceedings under Chapter 15 of the U.S. Bankruptcy Code.[4] The Cayman Proceedings were initiated by the Funds' respective boards of directors and resulted in a Cayman court ordering the liquidation and winding up of the Funds.[5] The Representatives then filed petitions in a U.S. Bankruptcy Court seeking recognition of the Cayman Proceedings as foreign main proceedings or foreign nonmain proceedings under Chapter 15[6]—a request the bankruptcy court denied.[7]

The bankruptcy court determined that the Funds' COMI was actually the United States, not the Cayman Islands.[8] In making this determination, the bankruptcy court relied upon the following facts: the Funds' investment manager was based in New York; the back-office administrator of the Funds was based in the United States, the Funds' books and records were in New York; and prior to the commencement of the Cayman Proceedings, virtually all of the Funds' assets were located in New York.[9]

On appeal, the district court addressed the issue of whether the bankruptcy court erred in determining that the Cayman Proceedings were neither foreign main proceedings nor foreign nonmain proceedings under Chapter 15 of the Bankruptcy Code.[10] In affirming the decision of the bankruptcy court, the district court observed that Chapter 15 provides a "simple, objective eligibility requirement for recognition . . . promot[ing] predictability and reliability."[11] This objective criterion is a factual inquiry based upon whether the debtor has its COMI in the country of foreign proceedings.[12] The district court found that the factual findings of the bankruptcy court were not clearly erroneous.[13]

Also at issue was whether the bankruptcy court properly, sua sponte, rebutted the presumption that the debtor's registered office is also its COMI without opposition by an interested party.[14] In affirming the bankruptcy court on this issue as well, the district court explained that Section 1516(c) of the Bankruptcy Code "creates no more than a rebuttable evidentiary presumption, which may be rebutted notwithstanding a lack of party opposition," and that the rebuttable presumption does not relieve the debtor of its burden of proof with respect to this issue.[15] Thus, for recognition as either a foreign main proceeding or foreign nonmain proceeding, a foreign debtor must establish through evidence that its COMI is in the foreign jurisdiction, which requires more than simply having its registered office in the foreign jurisdiction. Although principles of comity remain

4. *See Bear Stearns II*, 389 B R. at 327.
5. *See id.* at 329.
6. *See id.*
7. *See id.* at 330.
8. *Id.*
9. *Id.*
10. *See id.* at 327.
11. *Id.* at 333.
12. *See generally id.* at 333-34, 336.
13. *See generally id.* at 337-39. The court specifically held that the appellants failed to establish that "the Funds had a 'place of operations' that carried out 'nontransitory economic activity' in the Cayman Islands."
14. *See id.* at 334-35.
15. *Id.* at 335.

an important consideration for U.S. courts, under Chapter 15, recognition of the foreign proceeding is now a pre-condition to court access.[16]

II. Developments in the United Kingdom and Brazil

A. Cross-Border Insolvency In The United Kingdom In 2008

The Cross-Border Insolvency Regulations 2006 (CBIR) came into force April 4, 2006, and now applies to the whole of the United Kingdom, including Northern Ireland.

1. *Background*

The CBIR is the United Kingdom equivalent of Chapter 15 of the U.S. Bankruptcy Code, implementing the United Nations Commission on International Trade Law (UNCITRAL) model law harmonizing rules on cross-border insolvency. The United Kingdom also has in place its own Commonwealth basis of cooperation with Canada, Australia, and a number of the Caribbean islands,[17] plus it is bound by the European Union Regulation on Cross Border Insolvency, which operates between the member states of the European Union. There is also a more narrow common law discretion vested in the courts to assist on the basis of comity.

2. *Main Features*

Like Chapter 15, the CBIR provides access for foreign representatives and creditors to courts in the United Kingdom, and it gives rights to participate in an insolvency proceeding in the United Kingdom, subject to a request from their home court. The first use of the CBIR was by the U.S. Bankruptcy Court seeking recognition of a Chapter 7 case in England, *Rajapakse*, where the U.K. court gave guidance on how to proceed and what documents needed to be filed. Anecdotal evidence from the Registrars of the High Court suggests there are a number of applications now coming forward, but no case reports have resulted because the applications are not raising tendentious issues.

3. *Key Developments*

The key driver of the CBIR is to provide direct access for the person administering a foreign insolvency proceeding (the foreign representative) to the courts of the United Kingdom as well as to facilitate a temporary stay and allow the courts to determine what other relief or coordination is needed for the optimal disposition of the insolvency. Upon receipt of an application, the courts can grant relief to the maximum extent possible under Chapter IV. But what are the limits?

We have seen judicial caution in the United States with the *Bear Stearns I* judgment of Judge Lifland, in which the court refused to recognize a finding of the Cayman court as

16. *See id.* at 333.

17. Insolvency Act, 1986, c. 45, § 426 (U.K.), *available at* http://www.statutelaw.gov.uk/SearchResults.aspx?TYPE=QS&Title=Insolvency+Act&Year=1986&Number=45&LegType=All+Legislation.

main proceeding,[18] while Judge Drain in *SPhinX* also found that there was no main proceeding, but felt able to find sufficient jurisdiction to assist on a nonmain basis. Surprisingly, Judge Lifland has also recognized as a main proceeding a scheme under section 425 of the U.K. Companies Act 1985[19] which is not recognized as an insolvency proceeding in the United Kingdom, nor is it a process for which the U.K. government has sought recognition in the European Union.

There have, however, been two recent judgments of note from U.K. courts: one in the context of common law assistance with respect to Chapter 11 of the U.S. Bankruptcy Code, and another assisting Australian Courts under the Commonwealth cooperation regime, which clearly informs how the English courts will treat requests for assistance, including those issued under the CBIR.

4. *The Aptly Named Navigator Decision*

One of the features of the Commonwealth cooperation regime is that the any final appeals are made to the Judicial Committee of the House of Lords—in effect the United Kingdom's Supreme Court. Acting in this capacity, the judges sit as the Judicial Committee of the Privy Council. Although not technically binding as precedent in the United Kingdom, Privy Council judgments are persuasive and hardly ever ignored. In *Cambridge Gas Transport Corp. v. Official Committee of Unsecured Creditors (of Navigator Holdings PLC and others)* [hereinafter *Navigator*], Lord Hoffmann, giving the judgment of the court, mapped out the circumstances under which common law jurisdiction would support foreign insolvency courts seeking assistance.[20] The provisions of the CBIR were not strictly relevant, but the Isle of Man Court had a request from the U.S. Bankruptcy Court to assist in implementation of a Chapter 11 Plan to which one shareholder objected on jurisdictional grounds. Lord Hoffmann said:

> The English common law has traditionally taken the view that fairness between creditors requires that, ideally, bankruptcy proceedings should have universal application. There should be a single bankruptcy in which all creditors are entitled and required to prove. No one should have an advantage because he happens to live in a jurisdiction where more of the assets or fewer of the creditors are situated.[21]

This statement is an explicit reference to the doctrine of universality. The Chapter 11 Plan purported to deal with the worldwide assets of Navigator, leaving the question of whether the Isle of Man Court should exercise its common law jurisdiction to assist the U.S. court on this basis. The answer—emphatically yes!

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18. *See In re* Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 374 B.R. 122, 130 (Bankr. S.D.N.Y. 2007), *aff'd*, 389 B.R. 325 (S.D.N.Y. 2008). As was discussed above in Section I, Judge Lifland's decision was subsequently affirmed by the U.S. District Court for the Southern District of New York. *See In re Bear Stearns II*, 389 B.R. at 325.

19. Now restated in Section 895 of the Companies Act of 2006. Companies Act, 2006, 53 Eliz. 2, c. 46, § 895 (U.K.), *available at* http://www.statutelaw.gov.uk/SearchResults.aspx?TYPE=QS&Title=Companies+Act&Year=2006&Number=46&LegType=All+Legislation.

20. *See* Cambridge Gas Transp. Corp. v. Official Comm. of Unsecured Creditors (of Navigator Holdings PLC and others) [2006] UKPC 26, [2007] 1 A.C. 508 (appeal taken from Isle of Man) (U.K.), *available at* http://www.privy_council.org.uk.

21. *Id.* ¶ 16.

> [T]he underlying principle of universality is of equal application and this is given effect by recognising the person who is empowered under the foreign bankruptcy law to act on behalf of the insolvent company as entitled to do so in England. In addition, as Innes CJ said in the Transvaal case of Re African Farms 1906 TS 373, 377, in which an English company with assets in the Transvaal had been voluntarily wound up in England, "recognition carries with it the active assistance of the court." He went on to say that active assistance could include: a declaration, in effect, that the liquidator is entitled to deal with the Transvaal assets in the same way as if they were within the jurisdiction of the English courts, subject only to such conditions as the courts may impose for the protection of local creditors, or in recognition of the requirements of our local laws.
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> [T]hese principles are sufficient to confer upon the Manx court jurisdiction to assist the committee of creditors, as appointed representatives under the Chapter 11 order, to give effect to the plan. As there is no suggestion of prejudice to any creditor in the Isle of Man or local law which might be infringed, there can be no discretionary reason for withholding such assistance.
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> [T]he domestic court must at least be able to provide assistance by doing whatever it could have done in the case of a domestic insolvency. The purpose of recognition is to enable the foreign office holder or the creditors to avoid having to start parallel insolvency proceedings and to give them the remedies to which they would have been entitled if the equivalent proceedings had taken place in the domestic forum.[22]

Ultimately, the shareholders' objections were overridden. It is important to note that the judgment references cooperation where statutory authority is otherwise available under the CBIR. In those cases, the court can do anything authorized by the statute. But are there limits?

5. *McGrath v. Riddell and Non-Equal Sharing*

In *McGrath v. Riddell*, Lord Hoffmann again delivered the judgment where the Australian court had asked for assistance in the reorganization of insurer HIH.[23] Unlike the United Kingdom, in Australia, insurance reorganization involves payment of reinsured liabilities from reinsurance assets. The jurisdiction of the court in this case was statutory under section 426 of the U.K. Insolvency Act 1986. In relevant parts, Lord Hoffmann stated:

> The whole doctrine of ancillary winding up is based upon the premise that in such cases the English court may "disapply" parts of the statutory scheme by authorising the English liquidator to allow actions which he is obliged by statute to perform according to English law to be performed instead by the foreign liquidator according to the foreign law (including its rules of the conflict of laws.) These may or may not be the same as English law. Thus the ancillary liquidator is invariably authorised to leave the collection and distribution of foreign assets to the principal liquidator, notwithstanding that the statute requires him to perform these functions. Furthermore,

22. *Id.* ¶¶ 20-22.

23. McGrath v. Riddell [2008] UKHL 21 (appeal taken from Austl.) (U.K.), *available at* http://www.publications.parliament.uk/pa/ld200708/ldjudgmt/jd080409/mcgrat.pdf.

the process of collection of assets will include, for example, the use of powers to set aside voidable dispositions, which may differ very considerably from those in the English statutory scheme.[24]

This finding means that English courts receiving CBIR applications can assist in the application of the U.S. Bankruptcy Code in the United Kingdom, by statute. This allowance of assistance not only suggests a broad reach, it also means that U.S. preference rules may be applicable in the United Kingdom as a result of CBIR. It also represents a change of emphasis since the Bank of Credit and Commerce International (BCCI) cases of the early 1990s, where the English courts behaved in a more territorial fashion.

The notion that different rules from those operating in the U.K. insolvency regime will be supported by U.K. courts under CBIR is welcome to potential applicants for assistance from the United States. It means, for example, that in the case of Rule 2004 examinations, where the Fifth Amendment of the U.S. Constitution applies, the U.K. equivalent of section 236 examination (where there is no privilege) could be used. In effect, practitioners can now cherry pick procedures as they wish, at least as far as the assistance of the U.K. courts is concerned.

6. *Conclusion*

Comity is alive and well in the United Kingdom with four routes available to seek judicial assistance for insolvency cooperation. Lawyers in the United States have two routes open, but they could easily springboard from the United Kingdom into Europe or the old Imperial states with a well-planned execution in multi-state insolvencies. With London's continued status as the financial hub of Europe, and the credit crunch biting deeper still, this collaborative attitude is very welcome. What a pity Section 304 of the U.S. code was repealed at the time, of recent history, it was possibly most needed.

B. The Interplay of Arbitration and Insolvency Proceedings in Brazil in Light of Recent Court Precedents

Brazilian courts recently decided to uphold arbitration agreements during insolvency proceedings, recognizing the competence of the arbitrators designated by the parties to decide the controversy submitted to arbitration. Although these court precedents are only binding on the parties in the two cases at hand, we can conclude that these precedents are a trend that will be followed by the Brazilian judiciary branch in similar situations. Both cases are discussed below.

The first precedent involves two Brazilian entities operating healthcare plans, Interclínicas Planos de Saúde S/A (Interclínicas) and Saúde ABC Serviços Médico-Hospitalares Ltda. (Saúde ABC). Saúde ABC had acquired from Interclínicas, which is currently under *liquidação extrajudicial* [extrajudicial liquidation] proceedings, its entire client portfolio, pursuant to the terms and conditions of a certain portfolio purchase agreement entered

24. *Id.* ¶¶ 20-22.

into between Interclínicas, as seller, and Saúde ABC, as buyer.[25] The parties included an arbitration clause in the contract signed before Interclínicas became insolvent.

Brazil's *Lei de Falências e Recuperação de Empresa* [Company Recovery and Bankruptcy Law] does not apply to: (1) government owned and mixed-capital companies; or (2) financial institutions, credit cooperatives, pension funds, entities operating healthcare plans, insurance companies, saving companies, and entities subject to the same treatment as these entities.[26] When the entities operating healthcare plans become insolvent, they are subject to administrative winding-up proceedings known as extrajudicial liquidation under Brazilian law.

Interclínicas tried to avoid the arbitration by questioning the validity and enforceability of the arbitration clause. This issue was submitted for consideration to the *Superior Tribunal de Justiça* [Superior Court of Justice] (STJ).[27] The STJ held that the arbitration clause included in the contract was valid and enforceable because it had been agreed upon by the parties prior to the beginning of the extrajudicial liquidation proceedings of Interclínicas. Furthermore, in its decision, the STJ concluded that: (1) Interclínicas' participation in the arbitration did not represent any risk whatsoever to anyone involved in the extrajudicial liquidation proceedings, and (2) that the rights of the liquidated estate (and therefore the interests of creditors and third parties in general) could be adequately protected during the arbitration.

In addition, the STJ recognized that any decision as to the validity and scope of an arbitral award is ultimately within the jurisdiction of the arbitrators and not of the judicial courts, based on the competence principle (*Kompetenz-Kompetenz* principle) contained in Article 8 of Brazil's *Lei da Arbitragem* [Arbitration Law] which states:

> Article 8-The arbitration clause is autonomous from the contract in which it is included, meaning that the nullity of the latter does not necessarily imply the nullity of the arbitration clause.
> Sole Paragraph: The arbitrator is competent to decide, ex officio or at the parties' request, the issues concerning the existence, validity and effectiveness of the arbitration agreement, as well as of the contract containing the arbitration clause.[28]

The second precedent involves the Brazilian real estate company Jackson Empreendimentos Ltda. (Jackson) and the Brazilian construction company Diagrama Construtora Ltda. (Diagrama).[29] Diagrama and Jackson entered into a construction contract whereby

25. Interclínicas Planos de Saúde S.A. v. Saúde ABC Serviços Médico-Hospitalares Ltda., S.T.J.-S.P., M.C. No. 14.295 - SP (2008/0122928-4), Relator: Nancy Andrighi, 09.06.2008, D.Je. 13.06.2008 (Brazil) [hereinafter Interclínicas Planos de Saúde S.A.], *available at* https://ww2.stj.gov.br/revistaeletronica/REJ.cgi/MON?seq=4023374&formato=PDF. The court was considering a *Medida Cautelar* [provisional measure or protective measure] with Interclínicas Planos de Saúde S/A as Petitioner and Saúde ABC Serviços Médico-Hospitalares Ltda. as Respondent.

26. Lei No. 11.101 art. 2, de 9 de fevereiro de 2005, D.O.U. de 09.02.2005, edição extra - alterada. (Brazil), *available at* http://www.planalto.gov.br/ccivil_03/_Ato2004-2006/2005/Lei/L11101.htm.

27. The STJ is the highest Brazilian court in federal law issues and it is responsible for the recognition of foreign arbitral awards.

28. Lei No. 9.307, de 23 de setembro de 1996, D.O.U. de 24.09.1996. (Brazil), *available at* http://www.planalto.gov.br/ccivil_03/leis/L9307.htm.

29. Jackson Empreendimentos Ltda.v. Diagrama Construtora Ltda., T.J.S.P.-Câmara Especial de Falências e Recuperações Judiciais, Ag. In. 531.020-4/3-00, Relator: Des. Manoel de Queiroz Pereira Calças,

Diagrama was responsible for the construction of a building on behalf of Jackson. An arbitration clause was included to settle any disputes between the parties arising out of the contract in accordance with the International Chamber of Commerce (ICC) rules to be administrated by the *Câmara de Arbitragem do Instituto de Engenharia de São Paulo* [Arbitration Chamber of the Engineering Institute of São Paulo].

The building delivered by Diagrama was not satisfactory to Jackson, leading Jackson to file a request for arbitration against Diagrama for failure to duly execute the construction contract. Two months after the beginning of the arbitration proceedings, Diagrama was declared bankrupt. The *Administrador Judicial da Massa Falida* [Trustee of the Bankruptcy Estate] of Diagrama then submitted an opposition to the arbitration. The opposition of the Trustee, however, was denied and the arbitration proceedings continued. The arbitral tribunal issued an award favourable to Jackson, requiring Diagrama to pay damages in excess of 1.6 million Brazil reals (R$ 1,604,389.17).

Subsequently, Jackson filed a claim to participate in the bankruptcy proceedings of Diagrama. Initially, the *1ª Vara de Falências e Recuperações Judiciais da Comarca de São Paulo* [São Paulo Bankruptcy Court] rejected such claim, holding that the arbitration proceedings should have been suspended when Diagrama was officially declared bankrupt. Jackson then filed an *Agravo de Instrumento* [Interlocutory Appeal] in the *Tribunal de Justiça do Estado de São Paulo* (TJSP) [São Paulo Court of Appeals] against the decision and obtained a reversal. The *Câmara Especial de Falências e Recuperações Judiciais* [Special Chamber of Bankruptcies and Judicial Recoveries] of the TJSP examined the matter and decided to allow Jackson to seek the damages awarded by the arbitral tribunal before the bankruptcy court. It specifically held that the parties were fully capable of executing the arbitration agreement at the time that the underlying construction contract was signed and supervening facts, such as the company's bankruptcy, cannot annul an arbitration clause that has been validly executed and is legally enforceable.

Both precedents are important and indicate the future interplay of arbitration and insolvency proceedings in Brazil.

25.06.2008, (Brazil), *available at* http://esaj.tj.sp.gov/cjsp/getArquivo.do?cdAcordao=3254081. The case involved an *Agravo de Instrumento* [Interlocutory Appeal], with Jackson Empreendimentos Ltda. as Appellant and Diagrama Construtora Ltda. as Respondent.