In re Rose and the Limitations on Foreign Proceedings Entitled to Relief Under US Laws Governing Cross-Border Insolvencies

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A principal difficulty inherent in drafting a statute to govern cross-border insolvencies is identifying the types of foreign proceedings that are entitled to relief under the statute. Such relief typically involves nationwide injunctions prohibiting the commencement or continuation of actions or enforcement of judgments against the debtor-entity subject to the foreign proceeding, orders requiring the turnover of assets of the debtor-entity, and any other appropriate protections in furtherance of the foreign proceeding. In most cases, relief granted to entities subject to cross-border insolvency proceedings is far greater in scope than could be achieved through any non-bankruptcy appeal for comity, and is therefore often critical to the success of the foreign proceeding. If the types of foreign proceedings permitted to seek relief under a cross-border insolvency law are defined too narrowly, it will fail to account for the diversity of international law. If they are defined too broadly, the law will provide greater relief to foreign corporations than to their domestic counterparts. This tension often results in vague statutes that, for practical purposes, pass the problem onto the courts to decide.

In the recent case of *In re Rose*, a US bankruptcy court examined the limitations on the types of cases entitled to recognition and protection under section 304 of the US Bankruptcy Code (the 'Bankruptcy Code').[1] Though section 304 will soon be replaced with the new chapter 15 of the Bankruptcy Code (the US enactment of the United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency), the court's decision in *In re Rose* foreshadows issues certain to arise under chapter 15.

The factual background of *In re Rose*

In re Rose involved thirteen subsidiaries of the Aviva Group. All thirteen subsidiaries were solvent insurance providers that wrote a wide variety of general insurance and reinsurance policies in the London subscription market.[2] To eliminate administrative, financial, and regulatory inefficiencies, the subsidiaries had commenced a proceeding under Part VII of the United Kingdom Financial Services And Markets Act 2000 in the High Court of Justice in England (the 'English Proceeding').[3] As part of the English Proceeding, the High Court approved a transfer scheme (the 'Transfer Scheme') whereby most, but not all, of the assets and liabilities of twelve of the subsidiaries (the 'Transferor Subsidiaries') would be transferred to the thirteenth subsidiary (the 'Transferee Subsidiary'). Following the completion of the Transfer Scheme, the Transferor Subsidiaries would be deregulated and liquidated.[4]

On 18 March 2004, a representative of the Subsidiaries ('Mr. Rose') filed a petition under section 304 of the Bankruptcy Code seeking a permanent injunction to prevent creditors from collaterally attacking the Transfer Scheme by bringing law suits against the subsidiaries in the United States.[5]

In its order dated 29 December 2004, the US Bankruptcy Court for the Southern District of New York (Judge Prudence Beatty) rejected Mr. Rose's request for an injunction, holding that the subsidiaries' reorganization pursuant to the Transfer Scheme did not qualify as a proceeding entitling the subsidiaries to relief under section 304.[6]

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1 318 B.R. 771 (Bankr. S.D.N.Y. 2004).

2 *Id.* at 772–73

3 *Id.*; Petitioner's Post-Hearing Memorandum Of Law at 5, *In re Rose* (No. 04-11829) [hereinafter *Post-Hearing Memo*].

4 *In re Rose*, 318 B.R. at 772–73.

5 *Id.* at 772.

6 *Id.* at 776.

Foreign proceedings under section 304

Section 304 provides for the commencement of a 'case ancillary to a foreign proceeding.'[7] Following the proper commencement of such a case, a bankruptcy court in its discretion may 'enjoin the commencement or continuation of any action against a debtor with respect to property involved in such foreign proceeding.'[8]

The Bankruptcy Code defines 'foreign proceeding' as a 'proceeding, whether judicial or administrative and whether or not under bankruptcy law, in a foreign country in which the debtor's domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding, for the purpose of liquidating an estate, adjusting debts by composition, extension, or discharge, or effecting a reorganization.'[9] As one prominent commentator has noted, the Bankruptcy Code's definition of foreign proceeding limits those proceedings eligible for relief under section 304 in three ways.[10] First, the foreign process must be 'conducted under the auspices of an administrative of judicial reorganization.'[11] Second, it must be conducted 'for the purpose of (1) liquidating an estate, (2) adjusting debts by composition, extension, or discharge, or (3) effecting a reorganization.'[12] Finally, the foreign process must be pending in a country in which the debtor's domicile, residence, principal place of business, or principal assets are located.[13]

If the foreign process satisfies the Bankruptcy Code's definition, an authorized representative of the foreign proceeding may commence a section 304 case. However, relief under section 304 (typically a nationwide injunction against commencing or continuing legal actions, or an order for the turnover of assets) is not automatic, and courts determining whether to grant relief are required to conduct a balancing test, taking into consideration the following factors: '(1) just treatment of all holders of claims against or interests in such estate; (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding; (3) prevention of preferential or fraudulent dispositions of property of such estate; (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title; (5) comity; and (6) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.'[14]

The holding of *In re Rose*

The court in *In re Rose* determined that the subsidiaries' restructuring under Part VII of the United Kingdom Financial Services And Markets Act 2000 did not meet the requirements of a 'foreign proceeding' under the Bankruptcy Code, and thus denied Mr. Rose relief under section 304. The court's ruling turned on the Bankruptcy Code's requirement that a foreign proceeding must be conducted 'for the purpose of liquidating an estate, adjusting debts by composition, extension, or discharge, or effecting a reorganization.' Specifically at issue was the meaning of the Bankruptcy Code's use of the word 'reorganization.'

As the Bankruptcy Code does not contain a definition for the term 'reorganization,' Mr. Rose argued for a broad definition, consistent with the breadth of the term's common usage.[15] Citing several US cases, Mr. Rose established that, as used by US courts, the 'term ''reorganization'' includes a transfer of assets and liabilities that, like the [Transfer Scheme], changes the reorganized entities' capital structure, but leaves unchanged the ownership and operation of the reorganized business.'[16] Thus, Mr. Rose argued, the English Proceeding, which was conducted in order to bring about the subsidiaries' restructuring under the Transfer Scheme, was 'for the purpose of effecting a reorganization.'

Criticizing Mr. Rose's all-encompassing definition of 'reorganization,' the court opted to define the term in a manner it deemed to be more consistent with the entire definition of 'foreign proceeding,' the purpose of section 304, and the term's usage in US bankruptcy law.[17] As the court explained, 'Mr. Rose's attempt to isolate the word ''reorganization'' from the words

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7 11 U.S.C. § 304.

8 11 U.S.C. § 304(b)(1).

9 11 U.S.C. § 101(23).

10 A.N. Resnick & H.J. Sommer (eds.), *Collier on Bankruptcy* (Mathew Bender & Co., 2005), para. 304.02[1].

11 *Id.*

12 *Id.*

13 *Id.*

14 11 U.S.C. § 304(c).

15 *In re Rose*, 318 B.R. at 774; Post-Hearing Memo, *supra* note 3, at 13–17.

16 Post-Hearing Memo, *supra* note 3, at 13.

17 *In re Rose*, 318 B.R. at 774–75.

''liquidation,'' ''adjusting debts'' and ''discharge'' does not reflect the statute's intent, which indicates that a ''reorganization'' under this section should have characteristics of proceedings of the type that the adjectives immediately preceding that word have, as well as have characteristics of proceedings of the type described elsewhere in the Code, such as a Chapter 11 reorganization.'[18] The court noted that section 304's legislative history at times refers to a foreign proceeding as a 'foreign bankruptcy case.'[19]

Quoting from a US legal encyclopedia, the court further explained that '[t]he reorganization of a corporation in bankruptcy is distinguishable from a consolidation or merger. It is not ordinarily the combination of existing corporations, but is simply the completion by proper agreements and legal proceedings, of a business plan or scheme for winding up the affairs of, or foreclosing mortgages upon the property of insolvent corporations, and the organization of a new corporation to take over the property and business of the distressed one.'[20]

The court then summarily concluded that the Transfer Scheme was not a reorganization, as that term is used in the definition of 'foreign proceeding,' and denied Mr. Rose's request for an injunction.[21] The court did, however, explain that its decision was not based upon the solvency of the subsidiaries, as solvent businesses can seek relief under the Bankruptcy Code.[22] It also seems unlikely that the court based its decision on the form of the subsidiaries' restructuring, as US bankruptcies often effectuate essentially the same form of transaction through the going-concern sale of substantially all of a debtor's assets and transfer of some or all of its liabilities.[23]

It appears that the true reason for the court's decision was its belief that section 304 was intended only to be used to grant comity to procedures designed for the relief of financially distressed entities and their creditors. The subsidiaries were all solvent, operating businesses, and Mr. Rose did not present any evidence of financial distress, nor, significantly, did he present any evidence that the purpose of Part VII of the United Kingdom Financial Services And Markets Act 2000 was to provide relief to financially distressed companies. At trial, the court explained,

> [T]he problem I have is that you're dealing with [section 304] as if it works for some type of corporate reorganization, and that's what [the Subsidiaries are] expecting, a corporate reorganization. It doesn't have anything to do with the entire reorganization that the [Bankruptcy Code] is talking about, you know. I mean, all that we're doing here is effectuating a type of merger that English law doesn't directly permit and I'm not sure why I should use the bankruptcy code to solve a problem which is one of English corporate law.[24]

Limiting the use of section 304 to those proceedings that are designed for the relief of financially distressed entities is consistent with the section's legislative history, which indicates that section 304 applies to proceedings the purpose of which is liquidation or 'financial rehabilitation.'[25] However, most courts hold that the definition of 'foreign proceeding' should be broadly construed,[26] suggesting that the drafters of section 304 could have been more explicit if they desired a more limited interpretation of 'reorganization.' Furthermore, the definition of foreign proceeding explicitly states that a foreign proceeding does not need to proceed under a 'bankruptcy law,'[27] which would appear inconsistent with a requirement that the purpose of the proceeding be limited to the US bankruptcy conceptions of 'reorganization.' The Bankruptcy Code's definition of 'foreign proceeding' was obviously written so broadly that its meaning is open to debate. The decision of *In re Rose* does little to clarify the issue.

Foreign proceedings under chapter 15

Section 304 was recently repealed, to be replaced with a new chapter 15, which is the US enactment of the

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18 *Id.* at 775.

19 *Id.*

20 *Id.*

21 *Id.* at 776.

22 *Id.* at 775.

23 Under section 363 of the Bankruptcy Code, debtors under US bankruptcy protection can sell their assets, and the assumption of debt may often serve as consideration for such sales. *E.g.*, *Trans World Airlines, Inc.*, 2001 WL 1820326 (Bankr. D. Del. 2001). Additionally, the Bankruptcy Code specifically contemplates reorganizations under chapter 11 of the Bankruptcy Code involving the 'transfer of all or any part of the property of the debtor to [an existing entity],' and the 'merger or consolidation of the debtor.' 11 U.S.C. § 1123(a)(5).

24 Transcript of 4 June 2004 at 101–02, *In re Rose* (No. 04-11829).

25 S. Rep. No. 95-989, at 24 (1978).

26 *E.g.*, *In re Netia Holdings S.A.*, 277 B.R. 571, 580–581 (Bankr. S.D.N.Y. 2002).

27 11 U.S.C. § 101(23).

United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency (the 'Model Law').[28] The provisions of chapter 15 will take effect on 17 October 2005.

Like section 304, relief under chapter 15 will be limited to those entities subject to a 'foreign proceeding.' However, the definition of 'foreign proceeding' has been revised to mean '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.'[29]

Similar to the old definition of 'foreign proceeding,' the new definition requires that the proceeding be (1) an administrative or judicial process, and (2) conducted 'for the purpose of reorganization or liquidation.' However, the new definition of 'foreign proceeding' also requires that the proceeding must be conducted 'under a law *relating* to insolvency or adjustment of debt.' Neither chapter 15 nor the Model Law defines what is a 'law relating to insolvency or adjustment of debt,' and of the few countries that have enacted the Model Law,[30] there does not appear to be any reported cases to guide interpretation on this issue.[31]

However, both the legislative history of chapter 15 and the *Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency* explain that 'a law relating to insolvency or adjustment of debt' is meant to include 'all proceedings involving debtors in *severe financial distress*.'[32] It appears that the inclusion of this clause in the definition of 'foreign proceeding' was intended to limit the use of the law to foreign processes designed for the relief of financially distressed entities and their creditors. Unfortunately, 'a law relating to adjustment of debt' seems to invite a multitude of interpretations.

It seems clear that if the court in *In re Rose* were to rehear the case under chapter 15, the holding would be the same. Interestingly, however, the court's reasoning might need to be revised. The stated reason for the court's refusal to employ section 304 was that the subsidiaries' restructuring was not for the purpose of a 'reorganization,' as the term is commonly understood under US bankruptcy law. Although chapter 15 retains the requirement that the foreign proceeding be 'for the purpose of reorganization or liquidation,' a court should be wary of applying the Bankruptcy Code's understanding of these words. Chapter 15 is the US enactment of the Model Law, and it specifically provides that '[i]n interpreting this chapter, the court shall consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions.'[33] Limiting the interpretation of 'reorganization' to the meaning ascribed to it in US bankruptcy law would ignore the international nature of chapter 15.

Rather, were *In re Rose* to be decided under chapter 15, the court would likely find that the English Proceeding is not a 'foreign proceeding' because Part VII of the United Kingdom Financial Services And Markets Act 2000 is not a law designed for the relief of financially distressed entities and their creditors, or as chapter 15 puts it, a 'law relating to insolvency or adjustment of debt.' Unfortunately, because of the vagueness of the definition, the court would likely have to explain why the transfer of the subsidiaries' debt was not what chapter 15 refers to as an 'adjustment of debt.'

The vagueness of the Model Law is understandable. In identifying which proceedings should be able to seek relief, the drafters not only had to take into consideration the wide diversity of international insolvency proceedings, they also had to write a law in such a generic form so as to be able to be enacted (and interpreted) by countries around the globe and incorporated into existing insolvency laws. Although the vagueness may be a necessity, it, like section 304 before it, most certainly will provide fertile ground for divergent interpretations.

Notes

28 Title VIII of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23, 134–46.

29 *Id.* § 802, 119 Stat. at 145, to be codified as 11 U.S.C. § 101(23).

30 Currently only Eritrea, Japan, Mexico, Poland, Romania, South Africa, Montenegro (within Serbia and Montenegro), British Virgin Islands, and the United States of America have enacted the Model Law. *See* Status: 1997 – Model Law on Cross-border Insolvency <www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html>, 4 September 2005.

31 UNCITRAL reports cases relating to its conventions and model laws and as of 1 February 2005 does not report any cases applying the Model Law. CLOUT Abstracts <www.uncitral.org/uncitral/en/case_law/abstracts.html>, 4 September 2005.

32 H.R. Rep. No. 109-31, at 118 (2005) (emphasis added); *Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency*, para. 71, *available at* <http://www.uncitral.org/pdf/english/texts/insolven/insolvency-e.pdf>, 4 September 2005.

33 Pub. L. No. 109-8 § 801, 119 Stat. 23, 137, to be codified as 11 U.S.C. § 1508.