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Use and Misuse of U.S. Bankruptcy Courts in Foreign Restructurings

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Introduction

The restructuring of public debt through prepackaged or prenegotiated Chapter 11 proceedings has been a mainstay of United States bankruptcy practice for many years. Creditor protections in such restructurings are well-developed. They include, for example, the formation of ad hoc committees of bondholders representing the interests of all creditors in negotiations with the company, with such committees typically retaining legal and financial advisors to ensure that existing equity does not retain a disproportionate interest in the company. Although the process of negotiating and obtaining creditor approval in pre-packs is largely an out-of-court process, the bankruptcy court must nonetheless evaluate a plan of reorganization incorporating the restructuring in all cases where unanimous consent is required but cannot be obtained.

Because of the ubiquity of bonds issued pursuant to the Trust Indenture Act or otherwise containing unanimous consent requirements, in the "prepack" negotiation process all parties accept that basic creditor rights must be protected or the restructuring will fail. It is therefore common for both creditors and debtor to have a shared understanding of the "rules of the game," including that voting procedures must: be evenhanded, that the absolute priority rule must be respected, that creditors receive more in the restructuring than they would in a liquidation, and that any investment by old equity must be subject to a market test. It is that shared understanding that results in most prepackaged cases gaining approval on a consensual basis; everyone knows what happens if such consent is not obtained.

Many foreign-based companies have come to the United States to issue public debt, promising investors that United States law, including the Trust Indenture Act, would apply and that legal actions respecting the debt could be brought in the United States. However, because many countries have enacted restructuring regimes with significantly fewer creditor protections than Chapter 11, foreign issuers of United States public debt are beginning to seek to circumvent their obligations to United States bondholders through the use of truncated foreign proceedings. With increasing frequency, they are doing so by invoking § 304 of the Bankruptcy Code.

One could well argue that an issuer, who from the perspective of its United States creditors is "foreign" in name only, that seeks to restructure United States debt issued under the protections of United States law, should subject itself to the procedural and substantive creditor safeguards of the United States bankruptcy system. An even more forceful argument can be made that the use of § 304 described herein to compel dissenting creditors to accept inadequate restructurings profoundly alters the shared "rules of the game," departs unacceptably from congressional will, and should not be countenanced by United States bankruptcy courts.

Section 304 of the Bankruptcy Code

Section 304 of the Bankruptcy Code permits a representative of an overseas bankruptcy estate to use the United States bankruptcy courts to assist in the administration of a foreign insolvency case through obtaining orders providing for the turnover of property located in the United States, enjoining actions or the enforcement of judgments against property located in the United States, or granting "other appropriate relief."

This broad, undefined grant of authority has been characterized by courts as giving United States bankruptcy courts nearly a "blank check" in issuing orders in support of a foreign proceeding. "Other appropriate relief" has included issuing orders allowing foreign representatives to conduct Rule 2004 examinations, authorizing a foreign representative to maintain causes of action in the United States courts, and appointing a United States co-trustee. Significantly, the foreign representative need not identify assets in the United States to obtain "other appropriate relief." Accordingly, the most pervasive use of § 304 is to enjoin litigation in the United States that is brought by creditors seeking to establish their rights under United States law—even if such litigation does not threaten property being administered. In many of these instances foreign issuers require orders from a United States court because it would be impossible for them to return to the United States to raise additional capital in the future if a United States creditor was able to obtain a judgment for its defaulted debt. Through such § 304 injunctions, if upheld, United States creditors can be relegated to foreign courts and proceedings which lack notions of due process and any material creditor protections, notwithstanding express agreements by the debtor to the contrary.

Foreign Issuers' Attempts to Avoid Their Promises

A good example of a "foreign" issuer attempting to force a dissenting group of holders of TIA issued bonds that holds a significant minority percentage of debt to accept an unfavorable restructuring through § 304 is **In re Board of Directors of Muliticanal S.A.**, 314 B.R. 486 (Bankr. S.D. N.Y. 2004). The **Multicanal** case involved a cable operator headquartered in Argentina, who raised more than $500 million in debt in the late 1990s. Using agents, bankers, and lawyers in America, the company sought the protections of the United States securities market. More than 80% of the resulting five series of bonds were purchased by United States investors. The bonds were governed by a choice of law provision designating New York law and identified New York courts as a proper forum for litigation. Multicanal took advantage of the lower cost of funds available for borrowings made under New York Indentures. Similarly, it broadened investor appeal by qualifying the issues under the Trust Indenture Act, which promised that the repayment of the debt's principal or interest would never be impaired absent unanimous bondholder consent. Multicanal registered some of the bonds with the SEC.

Multicanal experienced financial difficulties after the devaluation of the Argentine peso in early 2002 and defaulted on all its financial debt. Thereafter, the company's cash position improved considerably, and it became clear that the company had sufficient free cash flow to repay all or substantial amounts of its overdue principal and interest. Yet, the company did not attempt to pay down its existing debt.

In fact, Multicanal did not propose a workout that honored its fundamental promise to repay principal and interest. Instead, it proposed a restructuring that would replace $527 million in debt with $220 million, eradicating between 56% and 70% of bondholders' investments, depending on the options they were to receive. The equity made available to bondholders was capped at 35%—that is, Multicanal's corporate parent—the powerful media conglomerate Groupo Clarin—would retain control of the company with 65% of the equity in return for a mere $15 million contribution on its part. None of the equity was made available to retail United States holders, or investors who were not Qualified Institutional Buyers under the securities laws. So, too, the $220 million replacement debt securities were not even offered to investors from the retail sector. The company offered no market test or fairness valuation for Clarin's $15 million.

There is little doubt that if the company's creditors were accorded the protections written into the indentures and provided by United States federal and state law, any workout would have included making the creditors whole, or at the very least would have required equity-holders to forego a substantial portion of its ownership in favor of giving creditors a share in the restructuring; however, none of that occurred.

Instead of adjusting its debt under a United States bankruptcy regime, Multicanal invoked a new and largely untested Argentine out-of-court restructuring mechanism called an *"Acuerdo Preventivo Extrajudicial"* or "APE." It is interesting to note that the APE rules on which Multicanal relied were not even in existence when the bonds were issued to United States investors.

The Argentine APE accords creditors very different substantive and procedural rights than they would have had under United States law. As a result, creditors lack any significant negotiating leverage and thus, predictably, appear to "support" economic restructurings that would be unheard of in a system of rights and protections analogous to those promised when the money was borrowed.

Under an APE, the restructuring company is not obliged to provide creditors with a liquidation analysis, give more value to creditors than they would get in a liquidation, or provide projections of its income and expenses so that creditors can assess what kind of a company it will be if they accept or reject the proposed restructuring. Multicanal also designed a voting procedure that facilitated the counting of "yes" votes and minimized and even excluded "no" votes. Similarly, the APE did not give creditors the protections of a trustee, a creditors committee, or even a single person or entity with any fiduciary duties to protect them. The grounds for creditor objection were extremely limited by statute; creditors were only able to object that the proposed restructuring misstated assets or liabilities or that the company counted the votes incorrectly. Any hope for a broader role by a "reviewing" court in an APE was so uncertain that it was characterized by Multicanal's own trial expert as being "enormously far from the idea of guaranteed justice." Finally, to add to the list of procedural problems, ex parte communications between the "reviewing" court and the debtor were common.

As for the actual review, the APE court did not evaluate the economic fairness or feasibility of the transaction; indeed, the debtor did not provide any information from which the reviewing court could make such an evaluation. There were no rights to discovery or an evidentiary hearing; Multicanal's creditors sought both and were granted neither. In United States terms, procedural due process was demonstrably lacking.

Finally, because Multicanal did not wish any scrutiny from the SEC in registering any replacement securities, it refused to offer any United States retail creditors any form of equity, instead offering cash. To get that cash, the small United States bondholders had to support the restructuring.

Multicanal turned to the United States bankruptcy court for "recognition" of its foreign APE under § 304. It did so for the avowed purpose of cutting off litigation in the United States seeking collection on the defaulted notes. The bankruptcy court granted a TRO under § 304 to halt the creditors' collection actions and oversaw expedited proceedings leading to a trial.

As a threshold pre-trial matter, the objecting creditors made a motion to dismiss the § 304 proceeding on the grounds that the Trust Indenture Act gave bondholders rights that could not be overridden by the APE mechanism, which at best and in theory might be considered as "majoritarian," rather than rights-based. The Trust Indenture Act provides, in part, that "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security... shall not be impaired or affected without the consent of such holder." The courts have read that right to be "absolute and unconditional." Indeed, Congress appears to have passed the Trust Indenture Act in conscious rejection of majority rule in bond workouts, based on a "concern about the motivation of insiders and quasi-insiders to destroy a bond issue through insider control, and the generally poor information about a prospective reorganization available to dispersed individual bondholders."

In the **Multicanal** litigation, the creditors argued that their rights to the principal and interest of their loan were "absolute and unconditional" under the TIA and could not be overridden by the APE without their consent. The bondholders argued that the only instance in which a foreign restructuring mechanism could even arguably override federal TIA rights was where the foreign regime granted creditors the same substantive and procedural rights as Congress granted creditors in a United States bankruptcy. Yet, the Argentine APE did not provide the essential cornerstones of the United States bankruptcy proceedings, including independent judges with the means, information, and authority to ensure that the restructuring was fair and feasible. As stated in the legislative history of the TIA, absent granting unanimous creditor protection of the return of principal and interest, Congress wanted workouts to be forced into the jurisdiction of a United States bankruptcy court, which would shine a bright-light on the substantive fairness of the plan, and believed that "[e]vasion of judicial scrutiny of the fairness of debt-readjustment plans" would be "prevented" by the prohibition on non-consensual impairment of noteholder rights. There was no dispute that these substantive and procedural rights were missing from the APE.

The bankruptcy court rejected the bondholders' argument as a matter of law and irrespective of the particulars concerning the Argentine APE. **In re Board of Directors of Multicanal S.A.**, 307 B.R. 384 (Bankr. S.D. N.Y. 2004). The court similarly rejected the bondholders' argument that the existence of TIA rights should inform the comity analysis under § 304—i.e., that, in making the balancing required under § 304, something like a "comity plus" standard should be utilized, given the importance of the TIA rights at stake.

Although the court determined that the rights granted by the TIA were federal in nature, the court held that these rights were essentially contractual. Having determined that mere contract rights were at stake, the court relied on **Canada Southern Ry. Co. v. Gebhard**, 109 U.S. 527, 3 S. Ct. 363, 27 L. Ed. 1020 (1883), and reasoned that "if foreign law can under certain circumstances trump the U.S. Constitution and preclude bondholders from enforcing their contractual rights," then surely § 304 could trump the contractual rights under the TIA. **Multicanal**, 307 B.R. at 390.

After trial, the court issued a decision construing § 304 and the prior case law as providing a narrower scope of review than the one urged by the objecting creditors, which would have entailed examining the substantive or procedural fairness under United States standards. Instead, the court stated that its primary function under § 304 was to determine the most "economical and expeditious administration of a foreign estate." The court held that it did not need to examine whether the bondholders' reasonable expectations were being frustrated by Multicanal's post hoc refusal to accord creditors the protections it promised when it borrowed the money. Finding "comity" to the foreign regime to be an overriding factor, the court believed that it was sufficient that, in satisfying the § 304 factors, certain aspects of the APE were, in the court's view, similar to United States prepackaged bankruptcies.

In its deference to principles of comity, the court observed that many creditors voted in favor of the APE—although the court acknowledged that there were clear voting irregularities in the APE. It is important to note that these irregularities were never shown to be tolerated in a United States proceeding. Even the court's finding that there was indeed disparity in the procedures for obtaining "yes" and "no" votes—i.e., Multicanal made it harder to vote "no" than to vote "yes"—was insufficient to withhold recognition. The court may have been motivated by the fact that the reviewing court in Argentina had similarly found that Multicanal had discriminated against "no" voters without requiring a re-vote to remedy the discrimination. The bankruptcy court here believed that the question here is not whether the APE should be confirmed as a United States Chapter 11 plan but whether it is entitled to recognition under § 304 and fundamental principles of due process. The court said "yes."

The United States court, however, did draw the line. It found that Multicanal discriminated against United States retail creditors who were unable to exercise the vote that other creditors had and were similarly forced to accept a type of consideration—cash—that the court found was worth substantially less than other offered forms of consideration—namely, new notes and equity. The court rejected Multicanal's many excuses for the discrimination, conditioning any United States recognition on the company remedying the discrimination. The court ordered that Multicanal give notice of its cure of discrimination to enable the objecting creditors to obtain judicial review. The bankruptcy court's decisions are being appealed, and the Argentine court has requested additional submissions regarding the status of the proceedings in the United States. Interestingly, as of this writing, Multicanal has not proposed any cure for the discrimination.

Another recent example of a foreign issuer adopting the strategy of avoiding the scrutiny of the Chapter 11 process through the combination of a foreign proceeding (another APE) and § 304 is **In re Cablevision S.A.**, 315 B.R. 818 (S.D. N.Y. 2004). Cablevision is a multi-system cable operator in Argentina. The company is owned by two United States entities, a Texas buy-out firm and a Colorado cable firm. As Multicanal did, Cablevision issued notes under indentures governed by United States and New York law, including the mandatory provisions of the Trust Indenture Act. Like Multicanal, Cablevision stopped making interest and principal payments in early 2002. Cablevision then sought to restructure its debt by using the Argentine APE in conjunction with a United States tender offer. As in Multicanal, the Cablevision tender offer promised a wholly-lopsided financial restructuring whereby more then $1 billion in principal and interest would be restructured for less than $300 million in debt, while the United States entities controlling Cablevision had their equity share reduced minimally from 100% to 80%.

The United States litigation spawned by the restructuring included creditor claims based on Cablevision's alleged violation of the federal tender offer rules and claims under the Trust Indenture Act. Litigation was commenced in the United States District Court for the Southern District of New York when Cablevision sought and obtained an emergency TRO from the United States bankruptcy court under § 304, effectively halting the district court litigation.

At this point, the creditors sought to withdraw the matter from the bankruptcy court and put it back before the district court. This motion was granted, as the district court held that withdrawal of the reference was mandatory as the creditors alleged that Cablevision's solicitation of creditor consents violated federal statutes, including the tender offer statutes and the TIA, and that the court was required to consider material and substantial federal statutes and their interaction with the Bankruptcy Code. **In re Cablevision S.A.**, 315 B.R. 818 (S.D. N.Y. 2004). The court went on to state that whether to extend comity to the APE was a determination for an Article III court, not the bankruptcy court. This was the first reported decision of which we are aware that withdrew the reference of a § 304 case. However, before the proceedings went any further, the parties reached a settlement.

Are **Multicanal** and **Cablevision** reconcilable? **Multicanal**, as a matter of law, held that the existence of United States federal rights did not change the analysis under § 304 at all. **Cablevision**, on the other hand, stands for the premise that courts need to determine the prioritization of the TIA, the federal tender offer rules, and § 304.

Chapter 11 Can Accommodate Foreign Restructurings

In contrast to the APE, a United States bankruptcy proceeding has several benefits to creditors and debtors. Creditors are protected by the absolute priority rule and the "best interests" test. The requirement that all creditors in a class must receive the same treatment limits manipulation of creditor votes. Bankruptcy court supervision of the voting process protects the integrity of the process and provides assurance to dissenting creditors. If these fundamental protections were present in **Multicanal**, its restructuring would not have been approved.

There seems to be little legitimate need for the use of § 304 in cases like **Multicanal** and **Cablevision**, where the only activity in the United States is litigation on notes expressly granted United States law and United States forum protections. Indeed, the Bankruptcy Code permits foreign-based companies to commence Chapter 11 proceedings in the United States, that would allow foreign issuers to honor their obligations in their indentures to abide by United States laws. The jurisdictional requirement for a foreign debtor is § 109 of the Bankruptcy Code, which only requires the ownership of property in the United States. The property requirement has been virtually no formal barrier at all; $194 in a bank account has been found sufficient.

Where a foreign debtor has voluntarily sought to use United States bankruptcy courts, courts have permitted such access to assist the rehabilitation of the debtor. For example, in **In re Aerovias Nacionales de Colombia S.A.**, 303 B.R. 1 (Bankr. S.D. N.Y. 2003), the court allowed a Columbian airline to prosecute a Chapter 11 case because the vast majority of creditors were well served by the United States proceedings.

Involuntary Chapter 11 Petitions Against Foreign Debtors

The willingness of United States bankruptcy courts to allow foreign debtors access to the bankruptcy system to facilitate restructuring has not typically been extended to creditors. The court in **Multicanal**, for example, abstained from an involuntary Chapter 11 petition commenced by the dissenting creditors because of its belief that any order it issued could not be enforced if the debtor proved to be uncooperative, i.e., "objective futility." However, the district court rejected this approach in an appeal from the dismissal of an involuntary case commenced by bondholders of a Brazilian company. **In re Globo Comunicacoes e Participacoes S.A.**, 317 B.R. 235 (S.D. N.Y. 2004). In that case, the bankruptcy court dismissed an involuntary petition based on, among other things, objective futility. The district court reversed and remanded, stating that as long as the bankruptcy court had personal jurisdiction over the foreign debtor consistent with due process requirements—which may be able to be satisfied from the contacts with the United States arising from the use of the United States capital markets—an involuntary proceeding could be sustained, regardless of difficulty in enforcing its orders.

Conclusion

These decisions serve as reminders why further judicial or congressional development of cross-border restructurings is necessary. Had creditors been given the protections written into the bonds and provided by United States law, any workout would have included making creditors whole (or nearly so) or required equity to forego all or a very substantial portion of its ownership and control in favor of giving creditors equity in lieu of repaying the debt. Yet, none of that occurred. Because the APE and other foreign insolvency regimes provide creditors fewer rights, they lack meaningful negotiating leverage and must "support" restructurings that would be unheard of in a system of protections analogous to those guaranteed when the money was borrowed.

The promise of predictability and clear procedural and substantive rules have led to the extraordinary success of United States capital markets—benefiting United States companies, United States investors, *and* foreign companies. When United States companies face financial crises, both debtors and creditors accept that a defined set of "rules of the game" are in place. However, when a foreign company invokes a wholly different set of post-hoc rules, the game changes completely. As the law in this area continues to develop in the United States and in foreign countries, investors must take into consideration the impact such changes—both favorable and unfavorable—could have on the value of their investments.

Research References: Norton Bankr. Law & Prac. 2d §§ 21A:1 to 21A:3, 152:38; Bankr. Serv., L Ed §§ 14:23 to 14:27

West's Key Number Digest, Bankruptcy 🔑 2341

From the Appellate Courts

RECENT DECISIONS FROM THE APPELLATE COURTS

THIRD CIRCUIT

Reconstituted Comm. of Unsecured Creditors v. New Jersey Dep't of Labor (In re United Healthcare System, Inc.), 396 F.3d 247 (3d Cir. 2005). Non-profit employer's obligation to reimburse New Jersey state agency for unemployment benefits paid to former employees is not tax pursuant to § 507(a)(8)(E). New Jersey unemployment law allows nonprofit employers to choose between periodic contribution, that sustains a general governmental undertaking and is therefore a tax, and subsequent reimbursement, that only reimburses the system for exact payments made by the government and is not a tax for bankruptcy purposes.

Research References: Norton Bankr. Law & Prac. 2d § 42:37; Bankr. Serv., L Ed §§ 25:288, 25:298

West's Key Number Digest, Bankruptcy ⚷ 2954, 2955

FIFTH CIRCUIT

Raspanti v. Keaty (In re Keaty), 397 F.3d 264 (5th Cir. 2005). Bankruptcy court erred by not giving preclusive effect to previous factual finding regarding willful and malicious injury. The fact that there was no trial or evidentiary hearing on the issue was not fatal to a determination that the dispute was "actually litigated."

SIXTH CIRCUIT

Weingarten Nostat, Inc. v. Service Merchandise Co., Inc., 396 F.3d 737 (6th Cir. 2005). Section 363 is applicable to a lease assignment under § 365, and therefore the appeal was moot pursuant to § 363(m) after motion to stay pending appeal was denied and debtor assigned lease.

Research References: Norton Bankr. Law & Prac. 2d §§ 37:16, 37:26, 39:32; Bankr. Serv., L Ed §§ 20:310, 21:410

West's Key Number Digest, Bankruptcy ⚷ 3086 to 3088

SEVENTH CIRCUIT

In re Weinschneider, 395 F.3d 401 (7th Cir. 2005). Debtor was not entitled to administrative expense priority for the attorney's fees and costs expended in his successful defense of a trustee turnover action, because the debtor's attorneys had not been employed as professionals pursuant to § 327.

Research References: Norton Bankr. Law & Prac. 2d §§ 25:1 to 25:3, 42:25; Bankr. Serv., L Ed §§ 16:80, 16:144, 42:282, 52:222

West's Key Number Digest, Bankruptcy ⚷ 2877, 3156 to 3157

NINTH CIRCUIT

Sherwood Partners, Inc. v. Lycos, Inc., 394 F.3d 1198 (9th Cir. 2005). Bankruptcy Code pre-empts California state insolvency preference statute, because power to avoid preferences was given to state receiver only, not to creditors.

Research References: Norton Bankr. Law & Prac. 2d §§ 57:8, 37:26, 39:32; Bankr. Serv., L Ed §§ 33:26, 33:304

West's Key Number Digest, Bankruptcy ⚷ 2002

United States v. Fowler (In re Fowler), 394 F.3d 1208 (9th Cir. 2005). Pursuant to § 348(d), IRS claim in Chapter 11 case for § 503(b) administrative expense retains its administrative expense priority after debtors' conversion to Chapter 13.

Research References: 8 Norton Bankr. Law & Prac. 2d § 348; Bankr. Serv., L Ed §§ 17:184, 17:217

West's Key Number Digest, Bankruptcy ⚷ 2332

Montana v. Goldin (In re Pegasus Gold Corp.), 394 F.3d 1189 (9th Cir. 2005). Under close-nexus test, bankruptcy court had related-to jurisdiction over postconfirmation adversary proceeding against the State of Montana involving state tort and contract claims involving implementation of the bankruptcy plan. The proceeding was nonetheless barred by Montana's 11th amendment sovereign immunity, because the State's environmental claims in its proof of claim were not logically related to postconfirmation cleanup disputes.

Research References: Norton Bankr. Law & Prac. 2d §§ 4:64, 14:3, 149:27;

West's Key Number Digest, Bankruptcy ⚷ 2049, 3569