

Tallying Involuntary Insolvency Proceedings in the Wake of Chapter 15

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Since the enactment of the Bankruptcy Act of 2005, two reported decisions by Bankruptcy Chief Judge **Stuart M. Bernstein** of the Southern District of New York have examined the issue of whether the court should dismiss, on abstention grounds, an involuntary bankruptcy petition brought forth by cross-border insolvencies. The first decision, *In re Euro-American Lodging Corp.* (*EALC*), 357 B.R. 700 (Bankr. S.D.N.Y. Jan. 9, 2007), resulted in the entry of a chapter 7 order for relief, notwithstanding the existence of a chapter 15 case before the same court. By contrast, the second decision, *In re Compañía de Alimentos Fargo S.A.* (*Fargo*), 376 B.R. 427 (Bankr. S.D.N.Y. Oct. 15, 2007), resulted in the dismissal of an involuntary chapter 11 petition based on policies and principles espoused by chapter 15, even though chapter 15 was not implicated. Same judge, similar legal questions—two contrary results.



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With the globalization of debtor-creditor relations and the adoption of chapter 15 in the United States, foreign creditors may be more inclined to bring a debtor before U.S. bankruptcy courts involuntarily

in an attempt to seek respite from foreign bankruptcy courts. If the *EALC* and *Fargo* decisions are the start of a judicial trend, the adjudication of private rights in such scenario will likely take place in a context of a reasonable balancing of private rights and the bankruptcy courts' overarching concern with notions of international judicial efficiency, cooperation and coordination. U.S. bankruptcy courts may thus use §305(a)(1) of the Bankruptcy Code to dismiss, stay or limit a case as needed to promote international cooperation and coordination and thereby facilitate the equitable distribution of a debtor's assets to all creditors. This judicial approach coupled with the courts' ample authority

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under §305(a)(1) of the Code to forego jurisdiction over a case should become an overriding tactical consideration for foreign creditors evaluating whether the filing of an involuntary bankruptcy petition in U.S. bankruptcy courts remains an available option in cross-border insolvency scenarios. Even though dismissal of an involuntary petition pursuant to §305(a)(1) of the Code is an *extraordinary* remedy, the *Fargo* decision instructs that "the pendency of a foreign proceeding alters the balance by introducing considerations of comity into the mix." *Fargo*, 376 B.R. at 435. Nonetheless, a comparative peek at the *EALC* and the *Fargo* decisions reveals

property. While the extension petition was pending, in May 2006 the French liquidator filed a chapter 15 petition for recognition of the French insolvency proceeding as a foreign main proceeding in the Southern District of New York. Both Euro-American and the secured lender opposed recognition and, in particular, the portion of the proposed form of recognition order that would have enforced the French injunction against the secured lender in the U.S. *EALC*, 357 B.R. at 704.

In June 2006, the secured lender, acting as the sole petitioning creditor, filed an involuntary chapter 7 petition against Euro-American while continuing to pursue a foreclosure action against the hotel property in the New York state court. Euro American contested the involuntary bankruptcy petition. In July 2006, in violation of the U.S. automatic stay triggered by the filing of the involuntary petition, the French court

Latin America Update

that the devil remains in the factual details, even after the enactment of chapter 15.

The EALC Decision

The *EALC* case has a complicated chronology. In February 2001, a French corporate group, S.N.C. Summersun et cie S.A., Summersun and S.A.R.I. Summersun Paris (collectively, Summersun), was placed into liquidation in a French commercial court. A court-appointed liquidator was charged with marshalling and liquidating Summersun's assets *worldwide*. Summersun owned a 65 percent equity interest in the Euro-American Lodging Corp. (Euro American), a U.S. company whose sole asset was a hotel property in New York that was pledged as collateral to a French entity that was the largest creditor in the case (the secured lender). In February 2006, the French liquidator filed a petition in the French court to expand the liquidation proceeding to include Euro American. In March 2006, the French court issued an injunction against the secured lender directing it to suspend its foreclosure against Euro American's hotel

issued an order extending the *Summersun* insolvency proceedings to include Euro American "with the creation of a unified mass of assets and liabilities" (the extension order). *Id.* The French court thus consolidated the assets and liabilities of the Summersun entities and Euro American. In August 2006, the court granted partial recognition of the French insolvency proceeding, thus recognizing it solely as to Summersun, and deferred recognition of the extension order and enforcement of the injunction against the secured lender with respect to Euro American's hotel property.

The main issue in *EALC* was whether the secured creditor had sustained its burden of proof under §303 of the Code. Euro American sought dismissal, though marginally, of the petition pursuant to §305(a)(1). Rather than filing a motion for abstention as required by §305(a)(1), however, Euro American stuck its request for abstention by dismissal at the end of its post trial brief. The secured lender did file a motion under §305(a)(1), but withdrew it after he and the French liquidator became allies with respect to both the chapter 7 and 15 petitions

pending before the court. In light of the main issue in the case, the court applied a typical §303 analysis and determined that the secured lender had satisfied the standards for an involuntary petition. Thus, in January 2007, the bankruptcy court entered an order for relief under chapter 7 against Euro American.

As to the French liquidator's petition for recognition of the extension order, the court again deferred consideration of recognition, stating that "it prefer[red] to hear the views of a chapter 7 trustee whose administration would be impacted before deciding whether or not or to what extent to recognize the extension order." *EALC*, 357 B.R. at 730.

The Fargo Decision

In 2002, Compañía de Alimentos Fargo (Alimentos Fargo), Argentina's largest manufacturer and distributor of bread and bakery products, organized under Argentine law, with its headquarters, the vast majority of its assets, business operations and creditors and all employees in Argentina, commenced a reorganization proceeding in an Argentine commercial court after defaulting on interest payments to several large unsecured noteholders. Two judicial administrators were respectively charged with the general administration of the case and the administration of claims.

In 2006, the noteholders¹ filed an involuntary chapter 11 petition against Alimentos Fargo in the Southern District of New York. Alimentos Fargo's U.S. assets consisted of one trademark and three trademark applications. The noteholders questioned the fairness and efficiency of the Argentine bankruptcy process and the Argentine judiciary. They were frustrated with the slow progress of the Argentine reorganization proceeding, and the fact that the Argentine bankruptcy laws did not provide the same safeguards provided by the U.S. bankruptcy laws (e.g., unlike secured creditors, the noteholders were enjoined from taking action against the company or its property). Moreover, the noteholders were disappointed with an appellate court's determination that cramped their ability to influence the outcome of the case by limiting their claims to the amount of unpaid pre-petition interest for purposes of voting on a reorganization plan. The Argentine appellate court reversed a decision of the Argentine bankruptcy court (agreeing with the noteholders) that, for voting and

distribution purposes, their claim should be calculated based on the face amount of the notes plus accrued and unpaid pre-petition interest. *Fargo*, 376 B.R. at 431. The adjudication of the noteholders' claim by the Argentine bankruptcy court thus was consistent with the provisions of the Code.

Alimentos Fargo contested the involuntary petition alleging, among other things, that it violated the automatic stay in effect in the Argentine reorganization proceeding. While conceding that there were certain procedural and substantive irregularities at the appellate court level, Alimentos Fargo moved for dismissal on various grounds including abstention under §305(a)(1) of the Code. The bankruptcy court granted Alimentos Fargo's motion to dismiss the involuntary petition.

Dismissal under §305(a)(1)

Dismissal under §305(a)(1) of the Code is appropriate if, after notice and a hearing, the court determines that the interests of creditors and the debtor would be better served by such dismissal. 11 U.S.C. §305(a)(1). The reasonable use of the court's power to dismiss (or abstain) is governed by seven factors: (1) economy and efficiency of administration; (2) whether another forum is available to protect the interests of both parties or there is already a pending proceeding in state court; (3) whether federal proceedings are necessary to reach a just and equitable solution; (4) whether there is an alternative means of achieving an equitable distribution of assets; (5) whether the debtor and the creditors are able to work out a less-expensive out-of-court arrangement that better serves all interests in the case; (6) whether a nonfederal insolvency has proceeded so far in those proceedings that it would be costly and time-consuming to start afresh with the federal bankruptcy process and (7) the purpose for which bankruptcy jurisdiction has been sought. *EALC*, 357 B.R. at 703; *Fargo*, 376 B.R. at 433. Judge Bernstein applied these factors in both cases.

A Chapter 7 Trustee Has Many Arrows in His Quiver

After a very brief analysis of the foregoing factors in *EALC*, the court found that a chapter 7 case may better serve the interests of creditors and the debtor. The court reasoned that the secured creditor was, in fact, pursuing its state court remedies to foreclose on the

hotel property (in fact, the secured creditor held a judgment from the U.S. state court that was entitled to full faith and credit by the bankruptcy court even though the judgment was under appeal). Since Euro American's only asset was the hotel property and the secured creditor was undersecured, no money would be available to satisfy its entire claim or make a distribution to other creditors. The secured creditor and Euro American had been tangled in litigation for 15 years, so there was no possibility of an out-of-court arrangement. Euro American was not the subject of a French insolvency proceeding, and the bankruptcy court had not yet recognized the extension order from the French court that would have included Euro American in Summersun's French liquidation proceeding.

The court did offer other options to achieve an equitable distribution of assets to the extent the chapter 7 trustee could sell the hotel property through an orderly sale procedure presumably after negotiating with the secured creditor to carve out a portion of the sale proceeds for the benefit of Euro American's few unpaid creditors, and the chapter 7 trustee could generate additional value by pursuing avoidance claims if appropriate. *EALC*, 357 B.R. at 729. Notably, Judge Bernstein did not defer to the French court and did not show concern about judicial efficiency, cooperation and coordination of the foreign proceeding and the local proceeding. It is apparent that his decision to decline the opportunity to use §305(a)(1) of the Code to dismiss the U.S. involuntary chapter 7 case in favor of the French liquidation proceeding turned on the crucial fact that the debtor, Euro American, was not subject to both the French liquidation proceeding and the U.S. bankruptcy proceeding, hence there was no parallel foreign proceeding pending. Judge Bernstein had not decided the recognition petition filed by the French liquidator one month before the secured creditor filed the involuntary petition.

In any case, implicit in Judge Bernstein's decision is the denial of recognition of the French court's order asserting insolvency jurisdiction over Euro American and its only asset, the U.S. hotel property. Euro American's connection to France was limited to its affiliation to its French parent and its relationship with its secured creditor and its hotel operator, which also was a French entity. Euro American did not

continued on page 64

¹ The petitioning foreign creditors were Rainbow Global High Yield Fund, Argo Capital Investors Fund, The Star Fund and the Rainmac Fund.

Latin America Update: Involuntary Insolvency Proceedings

from page 35

have assets or carried out any nontransitory economic activity in France. Therefore, under such circumstances it was not appropriate, nor judicially efficient or practical, for the French court to consider the administration outside its territorial limits of Euro American's sole asset. In any event, because the chapter 15 case² preceded the chapter 7 case, it is possible that the chapter 7 trustee will coordinate his case administration with the French liquidator so the value of the hotel property can be maximized and the interests of Euro-American and its creditors can be better served.

If You Want a Rainbow, You Have to Put Up with the Rain

In *Fargo*, even though an Argentine reorganization proceeding is similar to a U.S. chapter 11 case and the delay in the resolution of the reorganization proceeding did not seem to have been caused by the Argentine bankruptcy court, the noteholders quarreled with the perceived unfairness and inefficiency of the Argentine bankruptcy system and the Argentine judiciary. Alimentos Fargo conceded that the Argentine appellate court made procedural and substantive mistakes (e.g., by deciding an issue outside the record). *Fargo*, 376 B.R. at 436. According to Judge Bernstein, however, "a mistake does not automatically imply partiality, or worse, corruption." *Id.* After a well-reasoned analysis of the seven factors governing the court's decision as to whether to abstain by dismissal of the involuntary petition, weighing the totality of the evidence presented by each side, and an extensive comparative review of both bankruptcy systems, Judge Bernstein found that abstention under §305(a)(1) of the Code was appropriate under this set of circumstances as the Argentine court was capable of determining and adjusting the parties' rights in a fair and equitable manner. Moreover, the same debtor was the subject of both the Argentine proceeding and the U.S. involuntary proceeding, thus there was a parallel foreign proceeding pending.

The Argentine insolvency proceeding had progressed so far that the Argentine

bankruptcy court had even addressed the allowance and amount of the noteholders' claims for voting and distribution purposes. At the time of the U.S. involuntary filing, the noteholders were seeking review of the appellate court's decision to limit the amount of their claim for voting purposes by the Argentine Supreme Court of Justice, and it appeared as if the noteholders had engaged in forum-shopping in the United States (hoping to benefit from an expedited chapter 11 timeline) so that their claim would receive more favorable treatment under a chapter 11 plan governed by the Code or to increase their leverage in any negotiations. *Fargo*, 376 B.R. at 433-441. Thus, the noteholders bought into the Argentine reorganization proceeding despite its problems. *Id.* at 441.

Therefore, the court concluded that to start fresh with a parallel chapter 11 case in the United States would be inefficient and without any benefit, for even if the U.S. court confirmed a reorganization plan, such plan would have had to be presented to the Argentine court for approval. *Id.* The court believed that the Argentine bankruptcy system is well developed and its judiciary is independent and functional (e.g., there was no evidence before the court suggesting that the Argentine bankruptcy court or even the judicial administrators were vulnerable to political influence or that the judicial administrators could have *ex parte* contacts with the judiciary to truly disenfranchise the noteholders). Under the circumstances present in *Fargo*, the court's overarching concern with notions of international judicial efficiency, cooperation and coordination prevailed, and the Argentine insolvency proceeding was deserving of deference.

Reconciling Judge Bernstein's Reasoning

The biggest factual distinction between the *EALC* and the *Fargo* decisions is the existence of a parallel foreign insolvency proceeding involving the same debtor in *Fargo* and the absence of it in *EALC*. Moreover, Judge Bernstein seems to have applied chapter 15 principles in both cases to determine whether the interests of creditors and debtors would be better served by dismissal of the involuntary bankruptcy

petitions under §305(a)(1) of the Code. Finally, in *EALC*, the French court's assertion of extraterritorial insolvency jurisdiction over Euro American's U.S. asset violated one of the fundamental debtor protections provided by the U.S. bankruptcy laws: the automatic stay triggered by the filing of the involuntary petition. Ironically, the filing of the involuntary petition in *Fargo* violated the automatic stay of the Argentine bankruptcy laws. Accordingly, to reach a contrary result in either case would have been manifestly contrary to the public policy of the United States and repugnant by international standards.

In *EALC*, the debtor's center of main interest, without dispute, was in the United States, whereas in *Fargo* the debtor's center of main interest, also without dispute, was in Argentina. Hence, had Judge Bernstein recognized the French proceeding, it would likely have recognized it as a foreign non-main proceeding, or perhaps Judge Bernstein would have denied recognition as there was no foreign estate or "establishment" to be administered in France. In *Fargo*, on the other hand, had chapter 15 been implicated Judge Bernstein would likely have recognized the Argentine reorganization proceeding as a foreign main proceeding in light of Fargo's miniscule presence in the United States. In either hypothetical scenario, the practical effect of recognition would have been the same as it happened under the analyses that Judge Bernstein applied in both cases.

Conclusion

The devil is in the details and the complexities of the case. Thus, bringing a debtor before a U.S. bankruptcy court involuntarily remains a viable option for foreign creditors, despite the significance of chapter 15 and regardless of whether chapter 15 is directly or indirectly implicated. The existence of a foreign insolvency proceeding does alter the balance of private rights against considerations of comity, but it does not necessarily diminish the ability of foreign creditors to successfully initiate involuntary proceedings against debtors participating ostensibly or truly in foreign proceedings. ■

² Under §1504 of the Code, a chapter 15 case is commenced by the filing of a petition for recognition of a foreign proceeding under §1515. 11 U.S.C. §1504.