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Commotion over Comity: *In re RHTC Liquidating Co.* and Contemporaneous Bankruptcy Decisions Addressing 'Comity'

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For over a century, the doctrine of 'comity' has been a prominent feature of US cross-border commercial law. The term is essentially shorthand for the idea that US courts typically afford respect and recognition (i.e., enforcement) within the US to the judgment or decision of a non-US court – so long as that decision comports with those notions of 'fundamental fairness' that are common to American jurisprudence.

In the bankruptcy context, 'comity' forms the backbone for significant portions of the US Bankruptcy Code's Chapter 15. Chapter 15 – enacted in 2005 – provides a mechanism by which the administrators of non-US bankruptcy proceedings can obtain recognition of those proceedings, and further protection and assistance for them, inside the US.

But in at least some US Bankruptcy Courts, 'comity' only goes so far. Earlier this spring, US Bankruptcy Judge Thomas Argesti, of Pennsylvania's Western District, offered his understanding of where 'comity' stops – and where US bankruptcy proceedings begin. His decision – and two others issued only weeks earlier – afford important indicators of comity's use, and limits, in US Bankruptcy Courts.

In re RHTC Liquidating Co. (*RHTC Liquidating Co. v Union Pacific Railroad Company, et al.*)[2]

As of March, Judge Argesti presided over Chapter 15 proceedings commenced in furtherance of two companies – Canada's Railpower Technologies Corp. ('Railpower Canada') and its wholly-owned US subsidiary, Railpower US. The two Railpower entities commenced proceedings under the Canadian Companies Creditors' Arrangement Act ('CCAA') in Quebec in February 2009. Soon afterward, their court-appointed monitors, Ernst & Young, Inc., sought recognition of the Canadian Railpower cases in the US.

Railpower US' capital structure

Railpower US' assets and employees – and 90% of its creditors – were located in the US. The company was managed from offices in Erie, Pennsylvania. Nevertheless, it carried on its books an inter-company obligation of USD 66.9 million, owed to its Canadian parent. From the outset, Railpower US' American creditors asserted this 'intercompany debt' was, in fact, a contribution to equity which should be subordinate to their trade claims. Judge Argesti's predecessor, now-retired Judge Warren Bentz, therefore conditioned recognition of Railpower US' case upon his ability to review and approve any proposed distribution of Railpower US' assets. After the company's assets were sold, Judge Bentz further required segregation of the sale proceeds pending his authorization as to their distribution. Finally, after the Canadian monitors obtained a 'Claims Process Order' for the resolution of claims in the CCAA proceedings and sought that order's enforcement in the US, Judge Bentz further 'carved out' jurisdiction to adjudicate the inter-company claim if the trade creditors received anything less than a 100% distribution under the CCAA plan.

Sale of Railpower US' assets and administration of the Railpower estates

Railpower US' assets were sold – along with the assets of its Canadian parent – to R.J. Corman Group, LLC. Railpower US was left with USD 2 million in sale proceeds against USD 9.3 million in claims (other than the inter-company debt). The Canadian monitor indicated its intention to file a 'Notice of Disallowance' of the inter-company debt in the Canadian proceedings, but apparently never did. Meanwhile, approximately CND 700,000 was somehow 'upstreamed' from

Notes

1 This article provides a more detailed treatment of a prior post that appeared on the author's website, <www.southbaylawfirm.com>, *See* 'Comity Is Not Just a One-Way Street' <www.southbaylawfirm.com/blog/?p=686>. Please direct questions or comments regarding this article to mgood@southbaylawfirm.com.

2 424 B.R. 714 (Bankr. W.D. Pa. 2010).

Railpower US to Railpower Canada. Finally, despite the monitor's assurances to the contrary, Railpower Canada's largest shareholder – and an alleged secured creditor – sought relief in Quebec to place both Railpower entities into liquidation proceedings under Canada's Bankruptcy and Insolvency Act.

Commencement of an involuntary Chapter 7 case under the US Bankruptcy Code

Enough was enough for Railpower US' American creditors. In August 2009, they filed an involuntary Chapter 7 proceeding against Railpower US, seeking to regain control over the case – and Railpower US' assets – under the auspices of an American panel trustee.

The Canadian monitor requested abstention under Section 305 of the Bankruptcy Code. Significantly redrafted in the wake of Chapter 15's enactment, that section permits a US bankruptcy court to dismiss a bankruptcy case, or to suspend bankruptcy proceedings, if doing so would (1) better serve the interests of the creditors and the debtor; or (2) best serve the purposes of a recognised Chapter 15 case.

The decision

Judge Argesti's 14-page decision, in which he denied the monitors' motion and permitted the Chapter 7 case to proceed, is one of apparent first impression on this section where it regards a Chapter 15 case.

'Best interests of creditors'

Where the 'better interests of the creditors and the debtor' are concerned, Judge Argesti's discussion essentially boils down to the proposition that because creditors representing 85% – by number and by dollar amount – of Railpower US' case sought Chapter 7, those creditors have spoken for themselves as to what constitutes their 'best interests.'[3]

'Best interests of Chapter 15'

The more interesting aspect of the decision concerns Judge Argesti's discussion of whether or not the requested dismissal 'best serve[d] the purposes' of Railpower's Chapter 15 cases. For guidance on this issue, Judge Argesti turned to Chapter 15's statement of policy, set forth in Section 1501 ('Purpose and Scope of Application') – which states Chapter 15's purpose of furthering principles of comity and protecting the interests of all creditors. Then, proceeding point by point through each of the 5 enunciated principles behind the statute, he arrived at the conclusion that the purposes of Chapter 15 were not 'best served' by dismissing the involuntary Chapter 7 case. As a result, Railpower US' Chapter 7 case would be permitted to proceed.

RHTC's analysis

Judge Argesti's analysis appears to focus primarily on (i) the Canadian monitors' apparent delay in seeking disallowance of the inter-company debt in Canada; (ii) the 'upstreaming' of CND 700,000 to Railpower Canada; and (iii) the monitors' apparent failure, as of the commencement of the involuntary Chapter 7, to 'unwind' these transfers or to recover them from Railpower Canada for the benefit of Railpower US' creditors. It also rests on the fact that Railpower US was – for all purposes – a US debtor, with its assets and creditors located primarily in the US.

RHTC's view of 'comity'

In this context, and in response to the monitors' protestations that comity entitled them to judicial deference regarding the Chapter 15 proceedings, Judge Argesti noted that:

> 'comity is not just a one-way street. Just as this Court will defer to a [non-US] court if the circumstances require it, so too should a foreign court defer to this Court when appropriate. In this case it was clear from the start that [this Court] expressed reservations about the distribution of Railpower US assets in the Canadian [p]roceeding ... . The Monitor has [not] explained how this [reservation] is to be [addressed] unless the Canadian Court shows comity to this Court.'[4]

Other, contemporaneous views of 'comity'

Judge Argesti's decision in RHTC is one of a flurry of decisions on 'comity' that have issued recently from US Bankruptcy Courts. A complete discussion of each is beyond the scope of this very brief article, but at least two are worth mentioning.

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3 424 B.R. at 721 ('The Court starts with a presumption that these creditors have made a studied decision that their interests are best served by pursuing the involuntary Chapter 7 case rather than simply acquiescing in what happens in the Canadian [p]roceeding.').

4 424 B.R. at 725.

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In re Metcalfe & Mansfield Alternative Investments[5]

In *Metcalfe & Mansfield Alternative Investments* – another Canadian case, this one involving the collapse of the Canadian asset backed commercial paper market – New York Bankruptcy Judge Martin Glenn granted recognition and enforcement, within the US, of a Canadian confirmation order that provided third-party releases to various non-debtor market participants, including a number of American banks, dealers, note holders, asset providers, issuer trustees, and liquidity providers.

These third party releases were themselves the subject of appellate litigation in Canada, but eventually upheld as within the ambit of the CCAA. The monitors' request was based, first, on Section 1509, which requires that if a US Bankruptcy Court grants recognition in a foreign main proceeding, it '*shall* grant comity or cooperation to the foreign representative.'[6] Moreover, where recognition is granted, the US court '*may* provide additional assistance to [the] foreign representative,'[7] provided such assistance is 'consistent with the principles of comity' and serves one or more articulated policy goals set forth in Section 1507(b). The decision to provide such assistance 'is largely discretionary and turns on subjective factors that embody principles of comity.'[8] It is also subject to a general but narrowly construed 'public policy' restriction in Section 1506.

In granting recognition and enforcement, Judge Glenn observed that though such third-party releases were not commonly granted under US law, Chapter 15's restriction of comity to rulings 'consistent with US law and policy' does not mean *identical* with US law and policy.[9] Instead, the 'key determination' is 'whether the procedures used in [the foreign court] meet [US] fundamental standards of fairness.'[10]

'Fundamental standards of fairness' are understandably vague, and – beyond the basic idea of due process – often difficult to establish. In *Metcalfe & Mansfield Alternative Investments*, Judge Glenn essentially found that though the releases in question likely went beyond what would pass muster under US law, third party releases weren't completely unheard of in the US[11] – and moreover, the decision of a Canadian court of competent jurisdiction should be entitled to recognition as a matter of comity in any event.[12]

In re Lehman Brothers Holdings, et al.[13]

One of the many decisions spawned by the Lehman Brothers bankruptcy is a recent one involving New York Bankruptcy Judge James M. Peck's refusal to accord comity to the ruling of an English appeals court regarding the effect of agreements governing a very complex series of transactions known as the 'Dante Program.' The program provided for the creation of synthetic interests in certain reference entities (SPEs) through the creation of credit-linked notes, used to purchase highly rated collateral.

Though the facts of the case are extremely complex, their essence, at least for purposes of a treatment of 'comity,' are as follows: Lehman Brothers Special Financing, Inc. (LBSF) participated in the Dante Program by entering into swap agreements with the SPEs, such that LBSF was obligated to remit to the holder of the collateral periodic payments that would be used, along with the returns from the collateral, to fund distributions under the notes. The transaction documents (which were governed under English law) provided LBSF with the highest priority for its obligations – but provided further that in the case of various events of default (including the bankruptcy either of LBSF or its parent, Lehman Brothers Holdings, Inc. (LBHI)), this priority would shift to the note holders.

On 15 September 2008, LBSF's parent, LBHI, filed for Chapter 11 protection in New York. LBSF followed suit approximately three weeks later, on 3 October 2008. Various note holders subsequently commenced litigation against the holder of the collateral in London, seeking a determination that LBHI's bankruptcy filing – and LBSF's non-payment under the swap agreements – entitled them to priority of distribution. LBSF intervened in this litigation and opposed the note holders' request. The English Court found for the note holders, and its decision was upheld on appeal.

Meanwhile, in New York, LBSF sought a determination from Judge Peck that its bankruptcy and that of LBHI did *not* trigger the 'priority shift' to the note

Notes

5 421 B.R. 685 (Bankr. S.D.N.Y. 2010).
6 11 U.S.C. § 1509(b)(3).
7 11 U.S.C. § 1507(a).
8 421 B.R. at 697.
9 421 B.R. at 697 ('[t]he relief granted in the foreign proceeding and the relief available in a [US] proceeding need not be identical.').
10 *Id.*
11 421 B.R. at 697-698 ('While Second Circuit case law places narrow constraints on bankruptcy court approval of third-party non-debtor release and injunction provisions, the use of such provisions is not entirely precluded. The Second Circuit decision in *Metromedia* ... and the Ontario Court of Appeal decision in *Metcalfe* ... both reflect similar sensitivity to the circumstances justifying approving such provisions.').
12 421 B.R. at 698.
13 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

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holders. The collateral holder opposed this relief on the grounds that English Courts already had ruled on this issue – and, therefore, Judge Peck must defer to that ruling.

Judge Peck respectfully disagreed. While acknowledging the validity of the English judgment, he nevertheless affirmed that principles of comity did not *require* his recognition of it.[14] Moreover, the English Courts had specifically allowed room for Judge Peck's own determination – even where that determination was contrary to the English Court's:

> 'The English Courts did not consider any provisions of the Bankruptcy Code in connection with their decisions. Importantly, neither of the English Courts purported to bind this Court in any respect, and the High Court explicitly declined to 'preclude any request or other application made by the ... U.S. Bankruptcy Court.' ... Therefore, the English Courts have been most gracious in allowing room for this Court to express itself independently on matters of importance to the administration of the LBHI and LBSF bankruptcy cases. In applying the Bankruptcy Code to these facts, this Court recognizes that it is interpreting applicable law in a manner that will yield an outcome directly at odds with the judgment of the English Courts.'[15]

The basis for Judge Peck's divergence from the English Courts' judgment was the interest of US Bankruptcy Courts in resolving issues of US bankruptcy law – and, in particular, preserving the integrity of the bankruptcy estate and the protections afforded its assets (and, by extension, the protections afforded creditors who will share in the estate's proceeds).[16]

Conclusion: Reconciling RHTC with contemporaneous decisions

How is *RHTC* reconciled with these other, essentially contemporaneous decisions? And what do the decisions say as a whole about developing US notions of 'comity' in the insolvency setting?

Standing alone, Judge Argesti's decision might be limited to its comparatively unique facts. Even so, it should serve as a cautionary tale for representatives seeking to rely on principles of comity when administering business assets in the US. In addition to his more limited construction of 'comity,' Judge Argesti also noted that recognition of Railpower US' Chapter 15 case was itself subject to review and dismissal where subsequently developed evidence suggested that the company's 'Center of Main Interests' was not in Canada, but in the US.

None of these factors were concerns in *Metcalfe & Mansfield Alternative Investments*. But the differing results in *RHTC* and *Metcalfe* – both Canadian insolvencies for which Chapter 15 relief was sought (and granted) in the US – are perhaps best explained by the anticipated differing impact of the cases on US creditors. In *RHTC*, the monitors appeared unable or unwilling to prevent insiders of the debtor from diluting or denying altogether any recovery from US-based assets to US-based creditors of the debtor's US subsidiary. By contrast, the debtor's plan in *Metcalfe & Mansfield Alternative Investments* offered no such direct threat. The differences between Canadian and US law were therefore not troublesome to the US Bankruptcy Court in the latter case.

Likewise, *Lehman Brothers Special Investments* ultimately concerned the protection of a US debtor's Chapter 11 estate – and the estate's creditors. While acknowledging the validity of the English judgment, Judge Peck nevertheless relied upon the prerogative of the US Bankruptcy Code to determine the effect of that judgment in a US Bankruptcy Court. This prerogative was of special importance where the Code preserved 'greater protection' for the debtor's estate and for its creditors than would otherwise be available under non-bankruptcy law. In such circumstances, comity must give way to domestic concerns.

For anyone weighing strategy attendant to the American recognition of a non-US insolvency proceeding, or the effect of non-US law upon a US-based debtor's creditors, these decisions are vital reading.

Notes

14 422 B.R at 416 ('The English Courts authoritatively have interpreted the Transaction Documents in accordance with applicable English law. The Court, while respecting that determination as valid and binding between the parties, is not obliged to recognize a judgment rendered by a foreign court, but instead may choose to give *res judicata* effect on the basis of comity.')

15 422 B.R. at 417.

16 *Id.* ('Despite the resulting cross-border conflict, the United States has a strong interest in having a United States bankruptcy court resolve issues of bankruptcy law, particularly in a circumstance such as this where the relevant provisions of the Bankruptcy Code provide far greater protections than are available under applicable provisions of foreign law. *See, e.g., Bank of N.Y. v. Alison J. Treco (In re Treco)*, 240 F.3d 148, 159-60 (2d Cir.2001) (declining to extend comity to foreign proceeding where "special protected status that secured creditors enjoy under United States law" was lacking under applicable foreign law).').

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