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"Stress testing" Chapter 15 of the US Bankruptcy Code

KEY POINTS

- Chapter 15 is an administrative tool, not a tactical weapon – and the aim of cross-border administration is transparency and fairness across multiple, international tribunals.
- US bankruptcy courts may be free to view comity to a foreign representative as different from comity to a specific order in a non-US court (though this issue is not settled).
- The US Bankruptcy Code's "public policy" exception (s 1506) is very sparingly applied. It may be best to consider the statute's functional intent: to ensure a [generally] level playing field between international insolvency tribunals.
- Even relatively innocuous "reporting" requirements may be useful in ensuring transparency and fairness in cross-border case administration.

Earlier this year, a New York bankruptcy court sent an important message to warring parties in a US cross-border insolvency proceeding: Chapter 15 of the US Bankruptcy Code is an administrative tool – and not a tactical weapon.

In re Cozumel Caribe, S.A. de C.V., 508 B.R. 330 (Bankr. S.D.N.Y. 2014), issued in April 2014, offers practitioners both within and outside the US a glimpse into how the US Bankruptcy Code's recognition provisions were designed to function under the stress of heated litigation.

THE CONTEXT

Cozumel Caribe, S.A. de C.V., (Cozumel Caribe), the operating entity for Cozumel's Park Royal Cozumel hotel and resort, sought protection from its creditors in Mexico via a *concurso mercantile* (reorganisation) proceeding. Cozumel Caribe, along with seven affiliates, were joint obligors on two promissory notes (the Promissory Notes) in the aggregate amount of USD$103m.

The Promissory Notes were secured in part by hotel revenues that were to be deposited in various lock box accounts, including a cash management account in New York (the Cash Management Account), controlled and serviced by CT Investment Management (CTIM). The Promissory Notes were further guaranteed by Pablo Gonzalez Carbonell and Grupo Costamex, S.A. de C.V. (collectively, the Guarantors) via a guarantee agreement (the Guarantee Agreement).

THE CASE

As described in the decision (and also in an earlier decision addressing previous litigation between the same parties over the same basic facts – see *In re Cozumel Caribe, S.A. de C.V.*, 482 B.R. 96, 102 (Bankr. S.D.N.Y. 2012), Cozumel Caribe and its affiliates defaulted under the Promissory Notes in 2010. Further, Cozumel Caribe's affiliates ceased depositing hotel revenues into the lock box accounts. Cozumel Caribe initiated a single *concurso* proceeding in Mexico in May 2010.

Cozumel Caribe's cross-border proceeding is a small illustration of how creative – and how contentious – cross-border litigation can become:

- On May 27, 2010 – six days after commencement of Cozumel Caribe's *concurso* proceeding – Cozumel Caribe obtained an *ex parte* order from the district court in Mexico's Quintana Roo State staying any actions: (i) seeking to transfer, or apply against any outstanding indebtedness, funds in to the Cash Management Account and related lock box accounts; or (ii) enforcing the Guarantee Agreement. CTIM and Cozumel Caribe fought bitterly over the extent and scope of this *ex parte* order:
  - CTIM sought relief from the Second District Court of the City of Cancun, trying (unsuccessfully, even after an appeal) to suspend the *ex parte* order as it applied to Cozumel Caribe's non-debtor affiliates and the Guarantors.
  - In July 2010, Cozumel Caribe sought recognition under Chapter 15 of the US Bankruptcy Code for its *concurso* proceeding in New York's Southern District Bankruptcy Court. Concurrently, the company's foreign representative sought injunctive relief that essentially tracked the Quintana Roo District Court's prior *ex parte* order. Bankruptcy Judge Martin Glenn granted this relief on a preliminary basis.
  - CTIM filed a complaint for breach of contract directly against the Guarantors in the US District Court for the New York's Southern District. The Guarantors never appeared; however, Cozumel Caribe's foreign representative did appear – and requested that the district court extend comity to the Quintana Roo District Court's prior *ex parte* order and stay the action. As Judge Glenn had done in the bankruptcy court, the district court likewise granted this relief.
  - CTIM then returned to the bankruptcy court, filing an adversary proceeding to recover some or all of the funds in the cash management account based on the loan defaults, but (again) at the request of Cozumel Caribe's foreign representative, Judge Glenn stayed that action on the basis of comity to the *ex parte* order.
- With enforcement against Cozumel Caribe and the Guarantors stayed in

Mexico and in the US, the Guarantors commenced an action in a Mexican court against Bank of America (the indenture trustee under the Promissory Note) seeking to invalidate the Guarantee Agreement – despite the Guarantee Agreement's provision that it was governed by New York law, and despite the Guarantors' further agreement to submit to the jurisdiction of New York courts for enforcement of the Guarantee Agreement. The complaint was served on a bank teller in a Chicago branch of the bank; when no answer was filed, the Guarantors obtained a default judgment in Mexico invalidating the Guarantee Agreement. Bank of America challenged this default judgment in still another Mexican court proceeding that, as of the date of Judge Glenn's decision, was still pending.

- Cozumel Caribe's foreign representative claimed he was not involved in the Guarantors' efforts to invalidate the Guarantee Agreement; however, Judge Glenn observed – twice – that he "*promptly* called that judgment to the attention of the judge in [Cozumel Caribe's Mexican *concurso* proceeding]". (508 B.R. at n.5) (emphasis in original). Moreover, Cozumel Caribe's proposed *concurso* plan eliminated the Guarantee Agreement's obligations.

THE CONTROVERSY

Against this backdrop, and with Cozumel Caribe's *concurso* plan pending in Mexico, CTIM sought to terminate recognition of Cozumel Caribe's Chapter 15 proceeding in the US.

Bankruptcy Code s 1517(d) (which governs recognition under US insolvency law), is "[s]ubject to [Bankruptcy Code] s 1506…". Under s 1506, a US bankruptcy court can refuse to take an action governed by Chapter 15 "if the action would be manifestly contrary to the public policy of the United States" (508 B.R. at 335) (internal citations omitted). CTIM argued that because a court may withhold recognition based on s 1506, a court may also terminate recognition if s 1506 is no longer satisfied, ie, if continued recognition would be manifestly contrary to US public policy.

In support of its position, CTIM went on to point out that continued recognition of Cozumel Caribe's *concurso* proceeding would be "manifestly contrary to US public policy" because:

- despite the terms of the loan – and despite his representations to Judge Glenn – the foreign representative had listed CTIM's claim in the *concurso* proceeding at a fraction (USD$27m) of Cozumel Caribe's USD$103m debt;
- the foreign representative had used the recognition order not to protect Cozumel Caribe, but to block enforcement of the Guarantee Agreement in US District Court – and then (along with its affiliates and the Guarantors) sought to void the Guarantee Agreement in a Mexican court;
- Grupo Costamex (one of the guarantors) had used the US District Court's stay of litigation to try to transfer assets and cash to a new company for no consideration (the Costamex Spinoff), in contravention of the Guarantee Agreement;
- the foreign representative had used the *concurso* proceeding for tactical delay, indirectly suspending CTIM's enforcement rights; and
- the foreign representative had failed to comply with regular reporting requirements (508 B.R. at 335).

THE COURT'S CONCLUSION

At one level, the acrimony between Cozumel Caribe (and its affiliates and Guarantors) and CTIM (and the lenders) is understandable – even expected: forum-shopping is a common tactic in domestic US insolvency practice, so there is little surprise that the parties employed this tactic across national borders.

At another level, however, Cozumel Caribe's case is somewhat unusual in that it involved the parties' efforts to use the recognition process itself for tactical advantage. Judge Glenn's decision – and the reasoning behind it – offers important guidance on the role of Chapter 15 in such circumstances:

Chapter 15 is an administrative tool – and not a tactical weapon.

While mincing few words with either litigant, Judge Glenn's initial focus was on CTIM's continued efforts, in the US, to "undo" the effect of Cozumel Caribe's original *ex parte* stay order: "CTIM… cannot use this court to invalidate or circumvent proceedings in the Mexican courts. CTIM is not entitled to relief in this court because it feels slighted by decisions or actions in Mexican court proceedings…Dissatisfaction with rulings of the lower Mexican courts is the proper subject for Mexican appellate proceedings, but does not implicate the [r]ecognition [o]rder…If the [f]oreign [r]epresentative or his counsel has engaged in misconduct in this court, there are other means to address such issues… none of which are before the court on the present motion. While there may be extreme circumstances in which dismissal of a case is an appropriate sanction for misconduct, as is true for any litigation filed in a federal court, the court does not believe that such action is appropriate in this case on the present record." (508 B.R. at 336–37).

Section 1506's "public policy" exception is very sparingly applied

"The court is concerned by the inconsistent positions taken by the [f]oreign [r]epresentative in the Chapter 15 case and in the *[c]oncurso* [p]roceeding on the key issue of the amount of CTIM's claim. But CTIM has not shown that the court's grounds for granting recognition have ceased to exist or that continued recognition would be manifestly contrary to US public policy…To inquire into a specific foreign proceeding is not only inefficient and a waste of judicial resources, but more importantly, necessarily undermines the equitable and orderly distribution of a debtor's property by transforming a domestic court into a foreign appellate court where

Feature

Biog box

Michael D. Good, South Bay Law Firm's managing principal, brings over 20 years' experience to complex domestic and cross-border insolvency practice – including representation of foreign creditors in US insolvency proceedings, work in jointly administered cross-border insolvency proceedings, and consultation regarding Chapter 15 of the US Bankruptcy Code. Michael has written and spoken frequently inside and outside the US on Chapter 15. Email: mgood@southbaylawfirm.com

the creditors are always provided with the proverbial "second bite at the apple" (508 B.R. at 335-36, 337).

Comity to a foreign representative is different from comity to a specific order or form of relief in a non-US court

Judge Glenn made crystal clear that continued recognition of Cozumel Caribe's Mexican restructuring via a Chapter 15 proceeding was not an implicit acceptance of Cozumel Caribe's reorganisation: "Granting comity to orders of a foreign court is not an all or nothing exercise – some orders or judgments in the same case or proceeding may merit comity while others may not…" (508 B.R. at 336-37). "The [f]oreign [r]epresentative should take little comfort from the court's [present] ruling [regarding continued recognition]. [CTIM's] Motion raises very serious questions about the conduct of the [f]oreign [r]epresentative in this court and in the *[c]oncurso* [p]roceeding, as well as very serious questions about the conduct of the principals of [Cozumel Caribe]… If and when an order or judgment is entered in the *[c]oncurso* [p]roceeding for which the [f]oreign [r]epresentative seeks recognition and enforcement, this court can decide then whether to grant comity to the order or judgment. At the present time, though, the current status quo (with approximately USD$8m held in a CTIM-controlled bank account in New York) sufficiently protects CTIM's interests." (508 B.R. at 332-33).

Once again, Chapter 15 is an administrative tool – and the aim of administration is transparency and fairness.

Section 1518 of the US Bankruptcy Code provides a relatively innocuous "reporting" requirement in connection with ongoing US recognition of a non-US insolvency proceeding. Interestingly, Judge Glenn's decision suggests that this requirement serves an important purpose in cases where the parties are jockeying for tactical advantage in multiple, international forums: "Pursuant to this Order and the requirements of s 1518, however, the Foreign Representative shall keep this court informed of any developments involving not only the Foreign Debtor, but also the Guarantors and the Non-Debtor Affiliates, to the extent those developments affect the rights of CTIM or other creditors of [Cozumel Caribe] in this Chapter 15 case." (508 B.R. at 338).

SUMMARY

Judge Glenn's analysis raises several important, practical points regarding recognition practice in the US:

How "mandatory" is "mandatory comity"?

Section 1509(b)(3) provides that upon recognition, the bankruptcy court "shall grant comity or cooperation to the foreign representative". A number of courts have concluded, based on this language, that a court must grant comity, not only to the foreign representative but also to either a foreign law or a foreign court's order upon request by the foreign representative. See, eg, *CT Inv. Mgmt. Co., LLC v. Carbonell*, 2012 WL 92359 (S.D.N.Y. Jan. 11, 2012). But Cozumel Caribe separates the two, and indicates that comity extended to a foreign representative may not necessarily coincide with that extended to a specific foreign order or judgment. Practitioners should anticipate further case law discussion over the extent to which "mandatory comity" is truly "mandatory" for all orders or judgments entered by foreign courts.

The Bankruptcy Code's "public policy" exception (s 1506) is primarily intended to ensure a [generally] level playing field between international tribunals

A number of courts have defined US "public policy" (as mentioned in s 1506) in terms of what it does not mean (508 B.R. at 337) (citing *In re Ephedra Prods. Liab. Litig.*, 349 B.R. 333, 336 (S.D.N.Y.2006); *In re Metcalfe & Mansfield Alt. Invs.*, 421 B.R. 685, 697 (Bankr. S.D.N.Y.2010); *SNP Boat Serv. S.A. v Hotel Le St. James (In re SNP Boat Serv. S.A.)*, 483 B.R. 776, 786 (S.D.Fla.2011)). Few have discussed what it does mean. See, eg, *In re Qimonda AG*, 462 B.R. 165, 183 (Bankr. E.D. Va. 2011) aff'd sub nom. *Jaffe v Samsung Electronics Co, Ltd*, 737 F.3d 14 (4th Cir. 2013). Judge Glenn's discussion of this section suggests that a better way of thinking about the statute may be to consider it in terms of function, rather than definition: the broad wording of the statute simply indicates that US bankruptcy courts will go to some lengths to avoid "second-guessing" the decisions of a non-US tribunal, with the implicit understanding that such tribunals will, themselves, endeavour to render such decisions with an awareness of their impact on US-based parties.

Rules count

As noted earlier, Bankruptcy Code s 1518's reporting requirement – and Judge Glenn's employment of it to enforce transparency between tribunals – serves as a reminder that the US Bankruptcy Code's recognition provisions, though brief, nevertheless offer a comprehensive set of tools to ensure fairness and transparency in the administration of cross-border insolvencies. ■

Further reading

- Chapter 15 relief for naked ancillary proceedings: *In re Drawbridge and In re Bemarmara* (2014) 4 *CRI* 146.
- When will the court not assist a foreign insolvency proceeding? Recent experience in England, the US and Germany [2013] 3 *JIBFL* 159.
- Lexis PSL checklist: Recognition under Chapter 15 of the US Bankruptcy Code.
- Lexisnexis Randi Blog: Interview: Have recent cases provided greater clarity as to what courts expect from non-US organisations under Chapter 15 proceedings?