ALERT MEMORANDUM

SDNY Bankruptcy Court Recognizes Croatian Proceeding Settlement Agreement Despite Gibbs Rule

November 6, 2018

On October 24, 2018, Judge Glenn of the United States Bankruptcy Court in the Southern District of New York ("the Court") granted recognition and enforcement of Chapter 15 debtor Agrokor's settlement agreement approved under its Croatian administration proceedings, which compromised debt governed by New York and English law as part of an overall plan.[1] In his memorandum opinion, Judge Glenn addressed how comity applies to the settlement agreement within the United States under Agrokor's Chapter 15 proceedings.

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The Opinion discussed the underlying issue with the Gibbs Rule, a rule of English law that provides that an English law-governed debt cannot be discharged in a foreign insolvency proceeding. The Gibbs Rule has protected the rights of creditors of English law-governed debt for more than a hundred years. A majority of Agrokor's debt to be compromised under the settlement agreement is subject to English law, and the Court considered if and to what extent it should take into account the Gibbs Rule in deciding whether it should extend comity to the settlement agreement. The Court explored both the theory and criticism of the Gibbs Rule, but ultimately concluded that the Court can recognize and enforce the settlement agreement within the territorial bounds of the United States regardless of the Gibbs Rule. The Court particularly focused on how the Chapter 15 proceeding met all the factors the Court considers when giving comity to a foreign restructuring plan.

[1] *In re Agrokor d.d., et. al.*, No. 18-12104, 2018 WL 5298403 (Bankr. S.D.N.Y. Oct. 24, 2018) (the "Opinion").

Background

Agrokor

The Agrokor group, an owner of a supermarket chain and a producer of spring water and ice cream and frozen foods, is comprised of 155 direct and indirect subsidiaries. It is the largest private company by revenue in Croatia, where its revenue constitutes roughly 15 percent of Croatia's gross domestic product.[2]

Agrokor's total indebtedness is HRK 31.5 billion (approximately EUR 4.25 billion), including unsecured English law-governed debt amounting to EUR 1.66 billion, and New York law governed debt amounting to EUR 625 million.[3] Agrokor pursued refinancing transactions in late 2016, however those efforts did not ultimately prove successful, leading to liquidity pressures and the pursuit of other financing by Agrokor in early 2017.[4]

Ultimately, on April 7, 2017, Agrokor and various affiliates, totaling 77 companies based in Croatia, filed for the commencement of proceedings under Croatia's recently enacted "Act on the Extraordinary Administration Proceedings in Companies of Systemic Importance of the Republic of Croatia" (the "EA Law").[5] The proceedings were formally commenced by order of the Commercial Court of Zagreb (the "Croatian Court") through a series of orders in the following months. An additional 80 affiliates that were not based in Croatia did not seek protection under the EA Law.

The EA Law

The EA Law had been adopted on April 7, 2017, with the purpose of protecting the sustainability of "companies of systemic importance for the Republic of Croatia"[6] where the company or group's operations "affect the entire economic, social and financial stability of the Republic of Croatia."[7] The EA Law provides for a mechanism for the collective compromise of debts of corporate groups that have a principal place of business in Croatia and are created under Croatian law, even if they have operations in other countries.

The EA Law provides for the appointment of an extraordinary commissioner by the Croatian Court, who is proposed by the Croatian government, to represent the debtor.[8] A creditors' committee also is formed, and is granted certain approval rights over the disposition of property and incurrence of new debt. The EA Law also provides for certain financial reporting and a claims process for creditors.[9]

The EA Law provides for the resolution of the proceeding through the proposal and approval of a settlement agreement, which is similar to bankruptcy plans and analogous concepts in other jurisdictions. Any settlement agreement requires approval by creditor vote, and if the requisite approval is obtained, the settlement agreement compromises the debts held by all creditors against the company.[10]

Under the EA Law, there are two methods of approving a settlement agreement. It can be approved if (i) more than half of all creditors by number (including non-voting creditors) vote in favor of the settlement agreement and more than half of all creditors in each class by value of claims vote in favor, or (ii) two-thirds of the total creditors by claim value vote in favor.[11]

The Settlement Agreement

When Agrokor started its Croatian proceedings, the majority of its debt to be compromised under the

[2] *Id.* at *1, *4.
[3] *Id.* at *6.
[4] *Id.* at *5. "Agrokor began to experience liquidity strains because of, among other things, concerns arising from the failure of the F2 Club Loan syndication, the impact of the PIK Loan springing maturity clauses and the information provided in Agrokor's accounting records."
[5] *Id.*
[6] The EA Law determines the systemic importance of a company by the average number of employees and amount of balance sheet liabilities, including Croatian affiliates.
[7] Opinion, 2018 WL 5298403, at *1.
[8] *Id.* at *13.
[9] *Id.* at *13-14.
[10] *Id.* at *15.
[11] *Id.*

settlement agreement was governed by English law, and another portion was governed by New York law. The settlement agreement proposed a compromise of the Agrokor debtors' various debts. The agreement waterfall included four classes, including (i) unpaid pre-petition employee claims given priority under local law, (ii) claims under the Superpriority Term Facilities Agreements, (iii) unsecured claims, including the deficiency claims of secured creditors, guaranties of affiliates' debts and intercompany claims, and (iv) equity.[12]

The settlement agreement consolidated the debtors, such that affiliate debt guaranties were effectively eliminated, and holders of the English and New York law governed debt were expected to recover about 50 percent under the waterfall.[13] The plan also grants the trustee of the New York law notes a release. The settlement agreement was accepted by over 78 percent of the value of creditor claims entitled to vote, and the Croatian Court approved the plan.[14] Final approval of the settlement agreement is pending in the High Commercial Court in Croatia.[15]

Chapter 15 Recognition of the Croatian Proceeding

Agrokor and eight of its debtor affiliates filed Chapter 15 proceedings in the Southern District of New York in July 2018, seeking recognition of the Croatian Proceeding as a foreign main proceeding and asking the Court to recognize and enforce the settlement agreement.[16] No party in interest objected to the granting of such relief, and the Court granted Chapter 15 recognition of the Croatian Proceeding as a foreign main proceeding by an earlier order in September 2018.[17] However, the Court deferred on its decision to enter an order recognizing and enforcing the settlement agreement.

By way of separate proceeding, the courts of England and Switzerland also granted recognition to the foreign proceeding (where the English decision has been appealed).[18] The English court rejected a creditor's objections to recognition based on the consolidation of debtors and *pari passu* arguments. Courts in Slovenia, Serbia, Bosnia-Herzegovina and Montenegro denied recognition of the foreign main proceeding, based on concerns that the EA Law is not a general insolvency law and rather focuses on effects on the Croatian economy rather than the protection of creditors, and based on the role of the Croatian government under the law, among other reasons. Those decisions are subject to pending appeals in the respective courts.[19]

The Decision to Grant Comity To the Settlement Agreement

The central issue considered by the Court in determining whether to grant recognition to the settlement agreement was to what extent, if at all, it should consider the risk that an English court would not recognize and enforce the settlement agreement in light of the Gibbs Rule.

The Court walked through the history of the principles underlying recognition of foreign orders under Chapter 15, and that the law generally gives comity to another country's proceedings when the foreign court proceeding was procedurally fair, including by providing a full and fair opportunity for creditors to be heard, and recognition would not violate domestic U.S. public policy.[20] The Court also takes into consideration whether the plan was approved by the debtor's creditors and the foreign court.[21]

The Court readily concluded that aside from the Gibbs Rule issues, the comity analysis is fairly simple—no party objected to the granting of recognition of the Croatian Proceedings within the United States;[22] the

[12] *Id.* at *8.
[13] *Id.*
[14] *Id.* at *7.
[15] *Id.* at *1.
[16] *Id.*
[17] *Id.* at *2, citing Order, *In re Agrokor d.d., et. al.*, No. 18-12104, (Bankr. S.D.N.Y. Sept. 21, 2018), ECF No. 30.
[18] In England, Agrokor was the only debtor that filed, seeking recognition for the whole group.
[19] Opinion, 2018 WL 5298403, at *9-12.
[20] *Id.* at *17.
[21] *Id.* at *21.
[22] *Id.* at *17.

settlement agreement resulted from a process that was procedurally fair and indeed quite similar to plan confirmation standards under the Bankruptcy Code[23] and the settlement agreement met all the factors under the precedential *Finanz* decision to determine procedural fairness.[24] Among other things, creditors received proper notice of the proceedings, approved the plan with the requisite votes and were given the opportunity to object to the proposed relief (where over 90 objections to the settlement agreement were raised).

The Gibbs Rule

The Court then turned to consideration of whether the existence of the Gibbs Rule in English law would or should preclude recognition and enforcement of the settlement agreement in the United States.

When deciding whether to give comity to a foreign proceeding, a court takes into account the interests of the United States, the foreign state, and mutual interests of nations in international law.[25] Since a large amount of Agrokor's debt to be compromised under the settlement agreement is governed by English law, the Court felt bound to consider the existence of the Gibbs Rule and whether it changes the Court's decision to give comity to the settlement agreement. Under the Gibbs Rule,[26] English law-governed debt cannot be discharged by a foreign insolvency proceeding. The Gibbs Rule has its foundations in the view that, where parties have agreed to contract under English law, their contractual agreement should not be overridden by a foreign insolvency proceeding. This presents an obvious tension with principles of insolvency law that elevate insolvency principles over contractual rights. However, despite rising criticism, the Gibbs Rule has been good law for more than a hundred years.[27]

The Court rejected the proposition that such contractual principles should govern a court's ability to compromise debt in bankruptcy, instead pointing to earlier U.S. Supreme Court precedents that deemed bankruptcy proceedings to be *in rem* proceedings that can compromise debts and bind creditors who do not participate in the proceeding. The Court further endorsed the positions set out by Justice Ramesh of the Supreme Court of Singapore,[28] who argued that contracting parties should expect that their proceedings could be subject to proceedings in a foreign jurisdiction the debtor has a connection to.[29] According to the Court, an insolvency proceeding is different from a contractual dispute because it is a collective proceeding that determines all creditors' rights "for a slice of a pie that is not big enough to repay all creditors in full."[30] The Court pointed out that an insolvency proceeding involves a "societal choice" that should not be obstructed by individuals' contractual rights.[31]

Judge Glenn was careful to note that no determinations were being made about whether an English Court ultimately would enforce the settlement agreement and he recognized the risk an English court may not grant recognition, in which case the settlement agreement

[23] *Id.* at *17.
[24] *Id.* at *22. "(1) Whether creditors of the same class are treated equally in the distribution of assets; (2) whether the liquidators are considered fiduciaries and are held accountable to the court; (3) whether creditors have the rights to submit claims which, if denied, can be submitted to a bankruptcy court for adjudication; (4) whether the liquidators are required to give notice to potential claimants; (5) whether there are provisions for creditors meetings; (6) whether a foreign country's insolvency laws favor its own citizens; (7) whether all assets are marshalled before one body for centralized distribution; and (8) whether there are provisions for an automatic stay and for the lifting of such stays to facilitate the centralization of claims."
[25] *Id.* at *17.
[26] The Gibbs Rule takes its name from *Antony Gibbs & Sons v La Société Industrielle et Commerciale des Méteaux* (1890) LR 25 QBD 399.
[27] For more insight about recent developments involving the Gibbs Rule, see our separate publication, Investor Protections in England: the Non-Recognition of the Foreign Discharge of English Law-Governed Debt.
[28] Opinion, 2018 WL 5298403, at *24-25, discussing *Pacific Andes Resources Development Ltd.*, [2016] SGHC 210.
[29] *Id.*
[30] *Id.* at *25.
[31] *Id.*

likely would fail.[32] Ultimately, the Court reasoned that the fact that the Gibbs Rule does not recognize an American proceeding to discharge English debt was not a reason for the Court to refuse to recognize and enforce the settlement agreement within the territory of the United States as no U.S. public policy was at risk of being violated.[33]

Implications

Going forward, nothing in the Agrokor Opinion changes the Gibbs Rule. The Court acknowledged that creditors' rights in England for English law-governed debt are still preserved. Creditors of English law-governed debt can still go to English courts to challenge the enforcement of the settlement agreement for the English debt. The rule continues to provide an advantage to creditors of English law-governed debt, because another country's recognition of the foreign proceedings does not affect their rights to the debt in England. This provides predictability in the overall process as well, because each portion of an entity's debt will be adjudicated where they contracted for it.

On the other hand, the Opinion highlights the complexity of cross-border insolvency cases. Judge Glenn was ultimately not convinced that the Gibbs Rule would change the result of recognizing the settlement agreement, even after acknowledging that the Gibbs Rule may change the analysis. As the Opinion suggests, a court does not have to take into account every other country in its decision to give comity because the recognition of the settlement agreement is effective only in the territorial jurisdiction of the country where the court sits, in this case the United States. The Opinion therefore shows that, applying the principles of comity, it is difficult to achieve a centralized restructuring process in an international insolvency case if the Gibbs Rule limits the compromise of debts in other jurisdictions. The difficulty of achieving a uniform process to address the debt of a large, international group only adds complexity to the overall reorganization process for a group like Agrokor, but will seemingly continue with the tension between the principles of comity and the Gibbs Rule.

More broadly, if the Gibbs Rule remains good law following the resolution of ongoing English litigation where it is in issue,[34] then debtors' options may be limited to attempting to amend the debt instrument by contractual means (to the extent there is a collective action clause), or seeking to compromise debts by an English scheme of arrangement.[35] For creditors, there are issues around the enforceability of judgments on English law-governed debts where the debt has been purportedly compromised by a foreign insolvency proceeding, and a risk that a debtor may move assets out of England to avoid enforcement. In appropriate cases, where there is a real concern about enforcement, creditors may wish to consider seeking protection in the form of a freezing injunction or other injunctive relief to prevent assets being put out of reach.

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[32] The English courts have recognized that where a creditor appears in a foreign insolvency proceeding, that creditor may be taken to have consented to the foreign proceeding and therefore be bound by its outcome, notwithstanding the application of the Gibbs Rule: *Rubin v Eurofinance SA* [2012] UKSC 46.

[33] Opinion, 2018 WL 5298403, at *24, *26, where the Court noted that U.S. bankruptcy courts permit foreign insolvency proceedings to bind U.S. creditors, even where the debt is governed by New York law and has a forum selection clause in favor of the Courts of New York.

[34] There are ongoing English proceedings where the validity and effect of the Gibbs Rule is at issue: *Bakhshiyeva (Foreign Representative of the OJSC International Bank of Azerbaijan) v Sberbank & Others* [2018] EWHC 59 (Ch) where there is an outstanding appeal to the Court of Appeal, discussed in our separate publication at n.27 above.

[35] An English scheme of arrangement is a court-sanctioned proceeding where the terms of an English law-governed debt may be amended if approved by a majority of creditors by a number representing 75 percent in value. This is a powerful tool for debtors if the terms of their debt do not contain any collective amendment procedure or if their debt terms require a higher threshold for approval.