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Addressing Treatment of Equity Under Foreign Law and the Code

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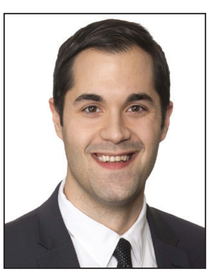

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Even as insolvency regimes continue to develop around the world, companies organized outside the U.S. are increasingly seeking to reorganize under chapter 11. Filing in the U.S. allows companies to take advantage of well-established law applied by sophisticated courts and, critically, provides access to a regime focused on reorganization and not liquidation. Chapter 11 contains tools to assist distressed companies in obtaining new funding, rejecting or renegotiating burdensome contracts, and protecting against continuing legal threats within and outside the U.S.

However, these benefits come with some challenges, particularly when a company's domestic laws may be seen to be at odds with the Bankruptcy Code. Although there are many potential conflicts, none is more fundamental than the potential clash between the Code's absolute-priority rule and the reality that under many foreign legal regimes, the exclusive right to approve and/or participate in a capital-raise is vested, at least in the first instance, with existing shareholders.

The Problem: Where Recovery to Equity Appears Both Forbidden and Mandatory

Codified in § 1129,[2] the absolute-priority rule is relatively straightforward: A class of creditors or shareholders generally cannot recover at the expense of a dissenting class of more senior creditors. This commonly means that absent the consent of impaired creditors or the contribution of new value, pre-petition equity receives nothing. Their shares are cancelled and new equity is issued, often through a rights offering conducted to raise the necessary capital to fund distributions and/or future operations.

Things are not so simple with a foreign debtor whose existing shareholders are vested with the exclusive right to determine when, how and how much equity should be raised.[3] A foreign debtor that needs to raise equity capital as part of its exit from chapter 11 might need to navigate the challenge of compliance with both (1) its own law, which may require the debtor to obtain shareholder approval for and/or provide its existing holders with the right to participate in such issuance; and (2) the absolute-priority rule, which, absent some exceptions, generally forbids recovery to existing shareholders over the dissent of impaired creditor classes.

Existing Tools in the Code Might Be Inadequate to Address the Problem

Conflicts between the Bankruptcy Code and nonbankruptcy law are not new. When faced with the potential that a plan might cause (or require) a violation of nonbankruptcy law, many debtors look to § 1123(a)(5).[4] Although the precise contours of its pre-emptive effect are far from certain, bankruptcy courts sometimes have relied on § 1123(a)(5) to confirm plans notwithstanding a violation of nonbankruptcy law, including laws restricting the distribution of assets or addressing corporate governance.[5]

Even though potential illegality is not a *per se* bar to confirmation, a plan that fails to comply with applicable foreign law would likely face significant challenges in satisfying other confirma-

1 The views expressed herein are those of the authors and not those of Cleary Gottlieb Steen & Hamilton LLP or Togut Segal & Segal LLP.
2 *See* 11 U.S.C. § 1129(b)(2)(B)(ii).
3 *See, e.g.*, Articles 189 and 199 of Aug. 10, 2016, bill no. 5730; Law No. 18046, Chilean Corporations Law, art. 25, Oct. 22, 1981, Diario Oficial [D.O.] (Chile).
4 *See* 11 U.S.C. § 1123(a)(5).
5 *See, e.g., In re 431 W. Ponce De Leon LLC*, 515 B.R. 660, 670 (Bankr. N.D. Ga. 2014); *In re Renegade Holdings Inc.*, 429 B.R. 502, 518 (Bankr. M.D.N.C. 2010).

tion requirements. Chief among those is feasibility, where courts have been clear that even if pre-empted, a plan's noncompliance with otherwise-applicable law might render it unfeasible.[6] These issues would be particularly acute in the foreign corporate law context. In order to issue equity, foreign debtors likely have myriad requirements to satisfy: approval by shareholders and boards of directors, registration with regulators, and/or certifications by counsel regarding compliance with applicable laws.[7] Although bankruptcy court approval might satisfy or obviate similar requirements for an American company,[8] a confirmation order is unlikely to act as a substitute for applicable foreign legal requirements, particularly when adjudicated by foreign courts.[9]

One potential way to thread this needle is to utilize an exception to the absolute-priority rule like the "new value" exception, which could permit compliance with foreign corporate law without violating the Bankruptcy Code.[10] An important and, thus far, not squarely answered question is how bankruptcy courts would ascribe value to a holder's consent to an equity issuance and/or waiver of its rights where that consent or waiver would appear to be the only means to achieve a confirmable plan.

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However, if a foreign debtor attempts to consummate a plan without complying with applicable foreign corporate and/or securities laws, it likely will face significant risk. Depending on the jurisdiction, a debtor and its board of directors might face a host of dire consequences, including the potential unwillingness of applicable regulatory bodies to approve and/or register the equity issuance, or possible civil or even criminal claims. At the board and management level, there might be reluctance to take or pursue actions where the debtor lacks real (or even apparent) authority to engage in such transactions, leaving aside the personal risk and exposure that may come with violating local law.[11] Even third-party agents typically hired to help implement such transactions might be reluctant to do so, or rely on indemnity and other arrangements that arise out of the execution of such transactions. Foreign debtors may also be subject to regulatory regimes or ownership qualification that could be violated by an equity issuance that violates local law.

There is also a risk that a local court or regulator determines that the newly issued equity is invalid and void, which could give rise to litigation by pre-petition creditors whose debt was exchanged for post-emergence equity. These risks would be material to the feasibility of a proposed plan, and could therefore create an independent basis on which applicable foreign laws could prevent confirmation of a noncompliant plan.[12] Beyond imperiling a plan's feasibility, the risk of protracted, expensive litigation also creates an enormous distraction at a critical time for a reorganized company, which could interfere with its ability to operate its business and obtain favorable financing at exit or afterward. Even the specter of such a battle could jeopardize other important negotiations pending in the case and provide leverage to opportunistic counterparties and lenders to exploit for their benefit and to the disadvantage of the estate.

Thus, where tension exists between the laws that govern a debtor's ability to issue new equity and the Bankruptcy Code, the pre-emption potentially available under the Code does not guarantee confirmation, and existing exceptions to the absolute-priority rule, although promising, are largely untested in this context. Moreover, and potentially more significantly, a bankruptcy court-approved plan that fails to comply with foreign law might not be implementable without significant, and perhaps existential, risk to the actual ability to consummate the restructuring and possibly even to the post-emergence debtor if the plan is consummated.

Existing Models for Resolving the Conflict Are Creative, but Uncertain and Expensive

Not surprisingly, parties faced with this potential thicket often have chosen to avoid disputes and have instead crafted practical workarounds when circumstances permit. Even then, the need to resolve the possible tension between the absolute-priority rule and foreign corporate laws unquestionably created inefficiencies and expenses that only served to divert resources away from recovery to creditors.

Solutions at the Plan-Proposal Stage: Pacific Drilling Finds a Workaround

Under Luxembourg law, a company's shares cannot be canceled, and the issuance of new shares requires the consent of 75 percent of existing shareholders.[13] This created a problem for

6 *See, e.g., In re Food City Inc.*, 110 B.R. 808, 812 n.10 (Bankr. W.D. Tex. 1990) (recognizing "legal consequences [that] might flow from the implementation" of plan that violates applicable law could affect feasibility); *see also In re Manchester Oaks Homeowners Ass'n Inc.*, 2014 WL 961167, at *4 (Bankr. E.D. Va. March 12, 2014).

7 Similar conflicts could arise from a debtor's attempt to consummate any number of corporate actions, such as the sale of all or substantially all of a debtor's assets, which not only might require shareholder approval, but might also trigger other consequences, such as a right of shareholders to redeem their stock or seek an appraisal of the sold assets. *See, e.g.*, Chilean Corporations Act art. 67 para. 2, no. 9.

8 *See, e.g., In re Stone & Webster Inc.*, 286 B.R. 532, 543 (Bankr. D. Del. 2002) (plan confirmation allows debtor to implement plan "without regard to ... other state corporation laws having bearing on the debtors"); *see also* 8 Del. C. § 303 (allowing debtor to carry out its reorganization plan "without further action by its directors or stockholders").

9 Even in the U.S., which is well known for its longstanding commitment to comity, courts will not extend comity to foreign court orders that contravene domestic public policy. *See, e.g., Victrix S.S. Co., SA v. Salen Dry Cargo AB*, 825 F.2d 709, 713 (2d Cir. 1987) (comity typically granted to foreign court orders except where "enforcement [would] prejudice the rights of United States citizens or violate domestic public policy").

10 *See, e.g., In re RAMZ Real Estate Co. LLC*, 510 B.R. 712, 718 (Bankr. S.D.N.Y. 2014).

11 Some might argue that a foreign debtor's election to file for chapter 11 should be seen as some kind of waiver of its domestic corporate laws to the extent inconsistent with the Bankruptcy Code. Such an argument would ignore that, generally speaking, shareholders' rights vest in the shareholders themselves. It is difficult to imagine stripping those rights from shareholders as a result of a debtor's actions, particularly where shareholders themselves did not authorize the chapter 11 filing.

12 *Cf., In re Walden Palms Condo. Ass'n Inc.*, 2020 WL 7586502, at *5 (Bankr. M.D. Fla. Dec. 21, 2020); *In re Wabash Valley Power Ass'n Inc.*, 1991 WL 11004220, at *74 (Bankr. S.D. Ind. Aug. 7, 1991).

13 *See supra* n.3.

the Luxembourg-incorporated debtors in *Pacific Drilling*, whose proposed plan was premised in part on an equity rights offering.[14] Absent the consent of impaired creditors (to comply with the absolute-priority rule) or shareholders (to comply with Luxembourg law), there was no simple means to avoid an in-court collision between the overlapping legal frameworks.

The ultimate resolution — avoiding impairment of junior creditors so as not to get tangled up in an absolute-priority challenge — required months of negotiation and significant compromise. First, senior creditors had to be convinced to support a plan that exchanged their debt for participation in a new debt and equity rights offering, but fully repaid junior creditors. This unimpairment was essential because it allowed the reinstatement of pre-petition equity without violating the absolute-priority rule. Next, the actual issuance required a massive equity offering, thereby diluting significantly existing equity and avoiding the need to cancel existing shares. Finally, the *Pacific Drilling* debtors had to secure the requisite supermajority shareholder support needed to issue additional shares. This final step was only possible with the consent of a single 78 percent majority shareholder, which came as part of a negotiated settlement that allowed it to participate in the equity rights offering and indemnified it against any potential Luxembourg law claims by dissenting shareholders. Having a single, controlling shareholder to negotiate with was critical to *Pacific Drilling*'s success. Debtors with more diverse shareholder bases are likely to face greater difficulty in achieving any requisite consents to issue new equity.

The proposed plan recently filed in the *Intelsat SA* proceeding in the Eastern District of Virginia appears to have a similar structure as *Pacific Drilling*.[15] It remains to be seen how the *Pacific Drilling* playbook will play out in *Intelsat*, whether before the bankruptcy court or, perhaps more likely, around the negotiating table among key stakeholders.

Solutions Early in (or Even Before) a Case

As *Pacific Drilling*'s experience demonstrates, addressing this potential conflict at the plan-confirmation stage can be an expensive and time-consuming endeavor, and can add significant uncertainty and risk. An alternative approach is to tackle the issue at the outset of a case — or even before commencement. This was the approach taken in *Alsacia* and *Maxcom*,[16] where debtors were able to reach agreement with impaired creditors to allow reinstatement of pre-petition equity, avoiding a potential collision between foreign equity laws (in these cases, Chile and Mexico) and the absolute-priority rule.

Another approach is to reach agreement with pre-petition shareholders to support a later issuance of equity as part of an exit from bankruptcy. This method was employed in *Aeroméxico*, where debtors sought and received approval of a $1 billion post-petition "debtor-in-possession" (DIP) facility that allows a portion of the DIP commitments to be converted into shares of the reorganized debtors at the option of the DIP lenders.[17] As part of the negotiation process, the *Aeroméxico* debtors entered into an agreement with holders of approximately 75 percent of existing capital stock, who agreed, among other things, to approve the capital increase that would be required to convert DIP commitments into reorganized equity if the DIP lenders so elect.[18] The *Avianca* debtors also have entered into a DIP facility that allows certain portions of the DIP commitments to be converted into reorganized equity.[19]

Potential Paths to Resolving a Potential Conflict

As the aforementioned examples demonstrate, although there might be ways for debtors to avoid a head-on collision between the absolute-priority rule and foreign corporate and securities laws, it is critical to address these issues as early as possible in order to avoid the management distractions, increased costs and inevitable delays that might accompany postponing engagement on this potential conflict. In the COVID-19 era in particular, timing the exit from chapter 11 is challenging enough for most debtors without layering on the possibility of a contentious, lengthy and value-destructive battle at the end of a case where no one wins but the lawyers. Ultimately, solutions and/or compromises will have to be crafted case by case, and stakeholders in foreign debtor cases will need to be prepared to think creatively and collaboratively to navigate the sometimes narrow space between the absolute-priority rule and the applicable laws that govern foreign debtors. abi

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14 *In re Pac. Drilling SA*, Case No. 17-17393 (Bankr. S.D.N.Y. 2017).
15 *See* ECF No. 1467, *In re Intelsat SA*, 20-32299 (Bankr. E.D. Va. Feb. 12, 2021).
16 *See* ECF No. 12, *In re Maxcom USA Telecom Inc.*, 19-23489 (Bankr. S.D.N.Y. Aug. 19, 2019); ECF No. 16, *In re Alsacia SA*, 14-12896 (Bankr. S.D.N.Y. Oct. 16, 2014).
17 *See* ECF No. 271, *In re Grupo Aeroméxico, S.A.B. de C.V.*, 20-11563, (Bankr. S.D.N.Y. Aug. 12, 2020).
18 *Id.*
19 *See* ECF No. 964, *In re Avianca Holdings SA*, 20-11133 (Bankr. S.D.N.Y. Sept. 21, 2020).