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Chapter 15 Five Years Out—a Canadian Perspective: Treatment of Cross-Border Insolvencies in United States Courts

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On April 20, 2005, Chapter 15 of the U.S. Bankruptcy Code, governing cross-border insolvencies, came into force as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. In marking the fifth anniversary of that milestone, we take a look back on two major decisions that have confirmed the broad and consistent respect for Canadian insolvency process in United States courts.

Chapter 15 is meant to provide an effective way of dealing with cross-border insolvencies with the objective of cooperation between courts of the United States and those of foreign countries (Bankruptcy Code Section 1501). However, the provisions of the Chapter also make it clear that nothing prevents a U.S. court from refusing to take an action governed by the Chapter if it would be manifestly contrary to the public policy of the United States (Section 1506).

When Chapter 15 came into force, it was a matter of concern to Canadian lawyers as to how U.S. courts would accommodate the above purpose and apply the above restriction. The approach of the U.S. courts under the old Section 304 of the U.S. Bankruptcy Code was one of comity and cooperation that allowed all involved in cross-border matters to develop insolvency strategies with a degree of confidence in their result. When Chapter 15 was introduced, many of us on the Canadian side of the border were anxious to see whether the introduction of Chapter 15 and, specifically Section 1506, would result in a marked difference of approach or application by U.S. courts.

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The *MuscleTech* Case

The first Canada-U.S. Chapter 15 case involved a Canadian company, MuscleTech Research and Development Inc. Here the scope of the public policy exception was explored by Judge Jed Rakoff of the U.S. District Court for the Southern District of New York. *In re Ephedra Products Liability Litigation*, (No. 04 MD 1598 (JSR); *In re Muscletech Research and Development Inc., et al.*, (No. 06 Civ. 538 (JSR); and *In re RSM Richter Inc., as foreign representative of Muscletech Research and Development Inc. and its subsidiaries*, (No. 06 Civ. 539 (JSR).

MuscleTech was a Canadian company that developed and sold health supplements, weight loss, and sports nutrition products. For the most part, the goods were manufactured, sold, and consumed in the United States.

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One of MuscleTech's best-selling products contained ''ephedra,'' an herbal supplement used to assist in weight loss or increase energy levels. Ephedra was subsequently banned by the U.S. Food and Drug Administration on the basis that it represented an unreasonable risk of illness or injury.

MuscleTech—along with many other U.S. corporations that sold products containing ephedra—was hit with a flood of lawsuits by plaintiffs who claimed to have suffered physical injuries (in some cases, including death) from the substance. In addition to product liability claims, a number of consumer class actions were commenced, but never certified, seeking substantial damages from MuscleTech for, in essence, false advertising.

In January 2006, MuscleTech began restructuring proceedings under provisions of the Canadian Companies' Creditors Arrangement Act (a Chapter 11-like process). Coincident with the CCAA filing, petitions seeking the recognition of the CCAA proceedings as foreign main proceedings under Chapter 15, were filed in the Southern District of New York. On March 2, 2006, Judge Rakoff recognized the Canadian proceedings as foreign main proceedings under Chapter 15 of the U.S. Bankruptcy Code.

Claims Resolution Order

As part of the Canadian restructuring, on June 8, 2006, the Canadian court made a Claims Resolution Order setting out a summary process for the resolution of claims by a Claims Officer (a retired Canadian judge) in Canada. This procedure was to apply equally to Canadian and U.S. claimants, including U.S. product liability and consumer claimants. The summary procedure precluded jury trials or an equivalent jury process.

The subsequent motion in the U.S. court to recognize the Canadian Claims Resolution Order was vigorously opposed by certain U.S. product liability claimants on the basis that the right to a jury trial was enshrined in the U.S. Constitution and, therefore, a foreign process that did not respect that right fell within the public policy exception of Chapter 15.

In an opinion dated Aug. 11, 2006, Judge Rakoff ruled that neither Section 1506 of Chapter 15, nor any other U.S. law, prevented a U.S. court from giving recognition and enforcement to a foreign insolvency procedure for liquidating claims simply because the procedure alone did not include a right to jury. Judge Rakoff reasoned as follows:

''In adopting Chapter 15, Congress instructed the courts that the exception provided therein for refusing to take actions 'manifestly contrary to the public policy of the United States' should be 'narrowly interpreted,' as (t)he word 'manifestly' in international usage restricts the public policy exception to the most fundamental policies of the United States.'' H.R. Rep. No. 109-31(I), at 109, as reprinted in 2005 U.S.C.C.A.N. 88, 172. This is the standard meaning accorded the word ''manifestly'' in international law when it refers to a nation's public policy.

Obviously, the constitutional right to a jury trial is an important component of our legal system, and § 1411 stresses its importance in the context of personal injury cases. But the notion that a fair and impartial verdict cannot be rendered in the absence of a jury trial defies the experience of most of the civilized world. Indeed, England, where the jury concept originated, has long since limited jury trials in civil proceedings to only those cases involving allegations of libel, slander, malicious prosecutions, fraud, and false imprisonment. *See* Richard L. Marcus, *Putting American Procedural Exceptionalism Into a Globalized Context*, 53 Am. J. Comp. L 709, 712-13 (2005) (internal quotation omitted).

Historic Function

The historic function of the jury to stand as a bulwark against government abuse plainly has limited application in the civil arena, and it is difficult to detect what unfairness a plaintiff suffers from having a civil case decided by a judge rather than a jury. Here, the objectors' primary claim of ''prejudice'' from the absence of a right to jury trial is simply that it will give them less of a bargaining position in negotiating a settlement of their claims than they would have if a jury—which, unlike the Claims Officer, would have no knowledge of competing claims—were asked to value their claims. *See* Tr., 7/6/2006, at 37, 40. Deprivation of such bargaining advantage hardly rises to the level of imposing on plaintiffs some fundamental unfairness.

This approach to the public policy exception was well received and appreciated by the Canadian insolvency bar.

It is interesting to note that Judge Rakoff ultimately recognized a Canadian order (see opinion and order dated March 7, 2007), that approved a plan of compromise and arrangement of MuscleTech containing wide-ranging third-party releases of solvent U.S. entities including retailers that sold the MuscleTech product. (The authors acted for one such retailer.) The issue of third-party releases is a subject matter of the second part of this article.

The Asset-Backed Commercial Paper Case

On Jan. 5, 2010, Judge Martin Glenn of the U.S. Bankruptcy Court for the Southern District of New York made an order recognizing and enforcing the amended sanction order and plan implementation order made by Canadian courts in the restructuring of the Canadian asset-backed commercial paper market (*In re Metcalfe & Mansfield Alternative Investments, et al.*, No. 09-16709 (MG) (Bankr. S.D.N.Y. 2010).

By way of background, during the week of Aug. 13, 2007, the market for Canadian non-bank asset backed commercial paper (ABCP) froze. The ABCP situation was similar to that experienced in the U.S. auction rate notes market in that issuers of Canadian ABCP could not roll their commercial paper on maturity and, for the most part, could not meet their payment and potential collateralization obligations under their ABCP.

The imperilled notes represented approximately $32 billion of principal liability, an exceedingly large number by Canadian standards, and a wholesale call on these notes was seen as a doomsday scenario for the ABCP issuers and sponsors, which included several Canadian commercial banks. Upon the market freezing, certain holders of ABCP (calling themselves the Pan-Canadian Investors Committee for Third-Party Structured Asset-Backed Commercial Paper) quickly entered into a standstill agreement with various market participants to prevent the collapse of the ABCP market. Once the market was stabilized by the standstill arrangement, the Committee set about restructuring the market for ABCP by commencing proceedings under the CCAA.

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Sweeping Global Release

Ultimately, a complex restructuring plan was approved by creditors and the Canadian courts. The plan effectively replaced the short term ABCP with longer term notes that matched the life of the underlying assets to the term of the notes. One of its central features was a sweeping global release of each of the participants in the Canadian ABCP market, including asset providers, sponsors, issuer trustees (represented by the authors and their firm), conduits, and the investors' committee from claims in any way related to the ABCP market in Canada.

The jurisdiction of the court of first instance in Canada to grant such third-party releases and related injunctions was hotly contested by some dissident ABCP note holders. The Canadian court ruled that it had such jurisdiction under the CCAA. The decision was affirmed by the Ontario Court of Appeal. Leave to appeal to the Supreme Court of Canada was denied.

The U.S. court was then asked to recognize and enforce the Canadian orders implementing the restructuring in order to bind U.S. parties. The relief was not opposed, but the court was troubled by the question of whether the U.S. court could properly enter an order enforcing the broad third-party non-debtor release and injunctions. The court concluded that it could.

Interestingly, the court held that it was far from clear that the third-party releases and injunctions would be within the jurisdiction of a U.S. bankruptcy court if brought forward in a U.S. plan. However, the court ruled that this question was not relevant to the proper inquiry–whether the Canadian foreign orders should be recognized and enforced in the United States in the Chapter 15 case.

The court turned to Section 1506 and cited with approval the *MuscleTech*/Ephedra case. In particular, the court agreed that the public policy exception embedded in Section 1506 should be narrowly interpreted as the word ''manifestly'' in international usage restricts public policy exceptions to the most fundamental policies of the United States.

Relief Need Not Be Identical

''The relief granted in the foreign proceeding and the relief available in a U.S. proceeding need not be identical. A U.S. bankruptcy court is not required to make an independent determination about the propriety of individual acts of a foreign court. See *In re Bd. of Dirs. of Multicanal SA*, 307 B.R. 384, 391 (Bankr. S.D.N.Y. 2004) (noting that neither case law nor Section 304 (the statutory predecessor to chapter 15) require a determination that the foreign proceeding is identical to the U.S. proceeding). The key determination required by this court is whether the procedures used in Canada meet our fundamental standards of fairness. See *Cunard S.S. Co. Ltd. v. Salen Reefer Servs. AB*, 773 F.2d 452, (2d Cir. 1985).''

The court concluded that Section 1506 did not preclude giving comity to the Canadian courts, and based its conclusion on the following principles:

- ''U.S. courts apply general comity principles in determining whether to recognize and enforce a foreign judgment.'' (*In re Metcalfe & Mansfield Alternative Investments*, et al., No. 09-16709 (MG), Corrected Memorandum Opinion of Judge Martin Glenn dated Jan, 5, 2010 at p. 21).
- ''The U.S. and Canada share the same common law traditions and fundamental principles of law. Canadian courts afford creditors a full and fair opportunity to be heard in a manner consistent with standards of U.S. due process. U.S. federal courts have repeatedly granted comity to Canadian proceedings.'' (same at p. 22).

The U.S. court went on to quote from a number of previous decisions of the S.D.N.Y, in which other Judges have noted that Canadian bankruptcy proceedings are similar in law and procedure to those of the United States and deserving of comity. With this jurisprudential background and having regard to the fact that the jurisdiction of the Canadian Court to make the orders to be recognized had been fully litigated and considered by the Canadian trial division, court of appeal and then had leave to appeal denied by the Supreme Court of Canada, the U.S. court treated the Canadian orders as res judicata and granted recognition under Chapter 15 of the U.S. Bankruptcy Code.

These two cases provide some comfort to Canadian lawyers that while the legislative framework may have changed, the approach of the US courts (at least in the Southern District of New York) to recognition and enforcement of Canadian orders made in insolvency proceedings remains one of comity and cooperation. U.S. court recognition of orders made in Canadian plenary proceedings is alive and well.