

Insolvency Notes

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Viability of "Deepening Insolvency" Cause of Action Continues to Generate Debate among the Courts

In the February 2005 issue of *Insolvency Notes*, we reported on the then recent decision of the Bankruptcy Court for the Southern District of New York in *In re Global Serv. Group LLC*, 316 B.R. 451 (Bankr. S.D.N.Y. 2004) and its rejection of the theory of "deepening insolvency" as an independent tort supporting the recovery of damages. The court summarized:

The Complaint alleges, in substance, that Atlantic Bank should be liable for [the debtor's] "deepening insolvency" because the bank made a loan that it knew or should have known [the debtor] could never repay. This may be bad banking, but it isn't a tort. A third party is not prohibited from extending credit to an insolvent entity; if it was, most companies in financial distress would be forced to liquidate.¹

Since then, a number of courts have taken their cue from *Global Service* and have either similarly rejected "deepening insolvency" as an independent tort or have questioned the appropriateness of the theory even where the court might believe itself constrained by *stare decisis* to refrain from dismissing a cause of action alleging "deepening insolvency." The unifying theme in these decisions may be little more than "bad facts make bad law."

In re Oakwood Homes Corp.

One of the more recent decisions dealing with whether a cause of action for "deepening insolvency" could withstand a motion to dismiss was decided on March 31, 2006 by the United States Bankruptcy Court for the District of Delaware in *In re Oakwood Homes Corp.*, 340 B.R. 510 (Bankr. D. Del. 2006).

In *Oakwood Homes*, a liquidating trust (the "OHC Liquidating Trust") objected to the proofs of claim filed by Credit Suisse First Boston ("CSFB") and asserted a number of "counterclaims" against CSFB, including a counterclaim for deepening insolvency. According to the OHC Liquidating Trust, CSFB had been the debtors' securities underwriter since at least 1994. In 1999, the debtors' business in the manufactured and modular home industry began to decline, and the debtors became insolvent or were in the vicinity of insolvency by 2000 and also experienced a reduction in liquidity at that time.² The lack of liquidity impeded the ability of the debtors to offer their customers retail installment sales contracts for the purchase of the modular homes sold by the debtors. To achieve greater liquidity,

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We welcome your comments and suggestions. If you have any questions or would like a copy of any of the relevant cases, please contact Maria K. Pum, Brian Holman, or any member of the Financial Restructuring and Insolvency Group.

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¹ *Global Serv.*, 316 B.R. at 459.

² *Oakwood Homes*, 340 B.R. at 516.

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the debtors securitized the installment contracts in an “asset-backed securitization process” that was “conceived, arranged, controlled, implemented, and underwritten by CSFB” who was also “serving as the debtors’ de facto restructuring and financial advisor.”³ As part of the securitization program, when default rates under the installment contracts rose, the debtors began to guarantee certain shortfalls in the payments on the installment contracts in order to induce investors to invest in the securities issued pursuant to the securitization program. They also, “with the encouragement of CSFB,” expanded a program (the “Loan Assumption Program” or “LAP”) where—under a defaulting obligor could find a third party to purchase the home and assume the remaining payments on the installment contract even though the third party was not necessarily credit-worthy. These programs, it was alleged, were not only unsustainable, but sapped the Debtors of cash that could have otherwise been used in their operations.

According to the complaint, CSFB encouraged the debtors’ use of the LAP program to enrich itself “through exorbitant fees and other remuneration, by prolonging the life of the Debtors’ securitization program that not only deepened the insolvency of the Debtors, but eventually drove them into bankruptcy.”⁴ Thereafter, in February 2001, CSFB also provided the Debtors with a \$200 million secured warehouse facility and demanded warrants to purchase just under 20 percent of the Debtors’ common stock, making CSFB “not only the Debtors’ underwriter, financial advisor and secured lender but also a powerful warrant holder.”⁵ In August 2002, CSFB formally became the Debtors’ exclusive restructuring and

financial advisor. On November 15, 2002, the Debtors filed voluntary chapter 11 petitions.

CSFB moved to dismiss nine of the ten “counterclaims” asserted by the OHC Liquidating Trust, including the claim of deepening insolvency. The court denied the motion outright with respect to eight of those counterclaims. However, with respect to the claim based on “deepening insolvency” the court decided to treat the motion to dismiss as “pending.” The primary reason for this was that the *Oakwood Homes* court was clearly persuaded by the reasoning of *Global Services* to the effect that “simply lending to an insolvent corporation without more, cannot possibly be a tort,”⁶ but it nevertheless could not follow *Global Services* because it was bound to follow the rule of *Official Comm. of Unsecured Creditors v. R.F. Lafferty Co., Inc.*, 267 F.3d 340 (3d Cir. 2001).⁷ The *Oakwood Homes* court stated:

Although this Court is aware of the mounting pile of authority rejecting such a cause of action [for deepening insolvency], this Court is bound to rule as the applicable state’s court of last resort would under the circumstances. [Citation to *Lafferty* omitted.] Put differently, this Court must determine what the Third Circuit would predict the state law was with regard to deepening insolvency as an independent tort. In light of the Third Circuit’s decision in *Lafferty*, this Court holds that Delaware, New York, and North Carolina courts would recognize deepening insolvency as a cause of action...

It is not for this Court to question the Third Circuit’s view of the soundness of the theory.⁸

³ *Id.*

⁴ *Id.* at 517.

⁵ *Id.*

⁶ *Id.* at 530 citing *Global Serv.*, 316 B.R. at 459.

⁷ The *Lafferty* decision was discussed in the February 2005 issue of *Insolvency Notes*. In that case, the Third Circuit determined that had it had occasion to do so, “the Pennsylvania Supreme Court would determine that ‘deepening insolvency’ may give rise to a cognizable injury.” 267 F.3d 349. In so finding, the *Lafferty* court was guided by “one of the most venerable principles in Pennsylvania jurisprudence, and in most common law jurisdictions . . . [that] where there is an injury, the law provides a remedy.” *Id.* at 350. As a result, the Third Circuit affirmed the district court’s decision that a deepening insolvency claim on behalf of the debtor corporation might succeed against the corporate insiders of the debtor who had perpetrated a Ponzi scheme, but that the doctrine of *in pari delicto* prevented the committee from pursuing those claims against outside professionals.

⁸ *Oakwood Homes*, 340 B.R. at 530-31.

In expressing its reservations about the vitality of an independent tort of deepening insolvency, the *Oakwood Homes* court acknowledged that not all recent decisions share its view of the (lack of) soundness of the theory. It then cited three decisions in which the courts found that a cause of action for deepening insolvency will withstand a motion to dismiss: *In re Student Fin. Corp.*, 335 B.R. 539 (D. Del. 2005); *In re Total Containment, Inc.*, 335 B.R. 589 (Bankr. E.D. Pa. 2005); and *In re LTV Steel Co.*, 333 B.R. 397 (Bankr. N.D. Ohio 2005).⁹ These decisions are discussed below.

In re Student Fin. Corp.

In *Student Fin. Corp.*, the Chapter 7 trustee of a Pennsylvania corporation (“SFC”) with its principal place of business in Delaware filed a complaint against the debtor’s pre-petition law firm, the individual attorney representing SFC pre-petition (“Gagné”), and various relatives of Gagné alleging various claims, including deepening insolvency. The defendants moved to dismiss arguing that the trustee lacked standing to bring that claim, that Pennsylvania does not recognize an independent cause of action for deepening insolvency, that the trustee had not alleged the necessary elements of a claim for deepening insolvency, and that the trustee failed to allege fraud with the necessary particularity. The first two challenges were defeated by *Lafferty*. As was the case with the creditors’ committee’s claims in *Lafferty*, the claims of the trustee in *Student Fin. Corp.* alleged damage to *the corporation* caused by the defendants’ conduct (as opposed to damage only to the debtor’s creditors), giving the trustee standing.¹⁰ Secondly, *Lafferty* established that deepening insolvency is a valid cause of action under Pennsylvania law. In so stating, the court expressed no reservations regarding the vitality of the deepening insolvency claim as an independent tort.

That left the court to examine whether the complaint sufficiently alleged the elements necessary to state a claim for deepening insolvency.

In considering this aspect of the defendants’ motion to dismiss, the *Student Fin. Corp.* court noted that the Third Circuit had not specified any particular elements of a claim for deepening insolvency in *Lafferty*. However, the *Student Fin. Corp.* court noted that the Third Circuit had identified the following allegation as describing the “injury” of deepening insolvency:

injury to the Debtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.¹¹

This observation by the *Lafferty* court had been interpreted by the District Court for the Eastern District of Pennsylvania as requiring that the tort of deepening insolvency requires a showing of fraud.¹² Thus, the *Student Fin. Corp.* court concluded that, to state a claim for deepening insolvency, the trustee had to allege that the defendants defrauded *the debtor*. Had the trustee alleged that defendants only defrauded the creditors, the trustee would lack standing to bring the claim.¹³ As it turned out, the trustee in *Student Fin. Corp.* did not allege that the defendants had defrauded the debtor, but merely that they had worked together to defraud SFC’s creditors. Therefore, the deepening insolvency claim was dismissed.

In re Total Containment, Inc.

As was the case in *Student Fin. Corp.*, the decision in *In re Total Containment, Inc.*, 335 B.R. 589 (Bankr. E.D. Pa. 2005) recognized deepening insolvency as a viable cause of action in its own right, but dismissed the cause of action with respect to the non-insider defendants for failure to state a claim.

⁹ *Id.* at 531.

¹⁰ *Student Fin. Corp.*, 335 B.R. at 548.

¹¹ 335 B.R. at 548 citing *Lafferty*, 267 F.3d at 347.

¹² 335 B.R. at 548 citing *Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp.*, No. 03-3020, slip op. at *4, 2004 WL 1900001 (E.D. Pa. 2001).

¹³ 335 B.R. at 548.

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In *Total Containment*, the debtor (“TCI”) was a Pennsylvania corporation that manufactured and distributed systems, products and services for the transportation of motor vehicle fuels from underground storage tanks to above-ground dispensers.¹⁴ The Chapter 11 trustee commenced an action asserting seven causes of action against eleven defendants, including one for deepening insolvency. In connection with that cause of action, the trustee alleged that, at a time when the debtor was insolvent, several defendants (many of whom were insiders or creditors of the debtor) perpetrated an elaborate scheme designed to siphon certain assets away from the debtor while saddling it with additional debt. The defendants moved for dismissal.

The trustee alleged that, as part of this scheme, the defendants created a new corporation (“PolyFlow”) that borrowed money from the creditor-defendants (who were also minority shareholders of the debtor) to purchase the debtor’s profitable pipe production business. In exchange for the pipe production business, the debtor received approximately \$3.5 million in cash, and PolyFlow assumed about \$2.5 million of the debtor’s debt owed to one of the defendant creditors. The trustee alleged that the debtor used all but \$9,000 to repay other debts owed to the various defendant creditors. The trustee alleged that these transactions provided no legitimate purpose or benefit to the debtor, but instead were undertaken for the purpose of shielding the pipe production assets from the debtor’s other creditors. The trustee further alleged that, after the sale of the pipe production business, the income from TCI’s remaining operations was insufficient to pay its creditors. However, the defendants, including

three officers or directors of TCI, continued to operate TCI in an effort to mislead other creditors into believing that the debtor was a going concern and to conceal the fraudulent transfers from such other creditors. As a result of this continued operation and the above alleged transactions, the trustee asserted that the defendants caused debtor’s insolvency to increase by more than \$17 million.¹⁵

In considering whether to dismiss the claim for deepening insolvency, the *Total Containment* court accepted that the claim was a viable theory of recovery based on *Lafferty* and its progeny.¹⁶ The focus of the court then turned to the defendants’ argument that the trustee was prohibited from bringing the claim of deepening insolvency against them because “the trustee, standing in the shoes of the debtor, is *in pari delicto* with the defendants: *i.e.*, that any wrongful conduct by the defendants can be imputed to the debtor and therefore the claim cannot stand.”¹⁷ *In pari delicto* is a doctrine that bars “the plaintiff from asserting ‘a claim against a defendant if the plaintiff bears fault for the claim.’”¹⁸ In considering that defense, the *Total Containment* court noted that, in *Lafferty*, the Third Circuit had held that the claim of deepening insolvency belongs to the corporation, not its creditors, and that, therefore, the trustee, pursuant to section 541 of the Bankruptcy Code, “has standing to bring the action, but is also subject to the affirmative defense of *in pari delicto*.”¹⁹ That doctrine applies as a defense to the deepening insolvency claim if the debtor corporation committed some wrongdoing.²⁰ In order for a defendant to avail itself of the *in pari delicto* defense, the defendant must demonstrate that the plaintiff is also at fault with the defendant. Although a corporation can only act through its officers,

¹⁴ 335 B.R. at 597.

¹⁵ *Id.* at 599.

¹⁶ The court also cited *In re Global Serv. Group, LLC*, 316 B.R. 451 (Bankr. S.D.N.Y. 2004), but only for the limited purpose of defining what the tort of deepening insolvency entails. *Total Containment*, 335 B.R. at 619.

¹⁷ 335 B.R. at 619.

¹⁸ *Id.* at 620 (citations omitted).

¹⁹ *Id.* at 620. In *Lafferty*, the Third Circuit explained that the issue of whether the *in pari delicto* doctrine applies depends on whether the defendant’s conduct could be imputed to the debtor corporation “and hence to the Committee, which... stands in the shoes of the Debtors. Imputation refers to the attribution of one person’s wrongdoing to another person.” 267 F.3d at 355.

²⁰ *Id.* at 621.

directors, and employees, not all actions of such insiders will be imputed to the corporation. For the wrongdoing of an *insider* defendant to be imputed to the corporation, the wrongdoing of the insider must be “committed (1) ‘in the course of [the officer or director’s] employment, and (2) for the benefit of the corporation.”²¹

In applying the doctrine of *in pari delicto* to the case before it, the *Total Containment* court considered that the doctrine is an affirmative defense that is generally not considered on a motion to dismiss unless the defense is established by the allegations in the complaint. The court found that the trustee’s complaint alleged facts, which if proved, would support a claim for deepening insolvency against the individual defendants and the two controlling shareholders of TCI, and that the face of the complaint did not establish the defense of *in pari delicto* for these defendants because the complaint alleged that the conduct of the defendants adversely affected TCI and benefited the defendants. However, the facts alleged in the complaint did not support a deepening insolvency claim against the non-insider defendants because the allegations did not support a finding that these defendants were involved with the continued operations of TCI, “let alone that they acted tortiously in the accretion of future debt by the debtor.”²² Thus, the claim of deepening insolvency against the non-insider defendants was dismissed.

In re LTV Steel Co., Inc.

The third case which *Oakwood Homes* cited among its examples of recent decisions embracing deepening insolvency as an independent claim is

In re LTV Steel Co., Inc., 333 B.R. 397 (Bankr. N.D. Ohio 2005). *LTV* arose in the context of a motion by an administrative claimant’s committee (“ACC”) seeking derivative standing to pursue a number of fraud-related claims against the debtors’ officers and directors, including claims for deepening insolvency. The debtors filed a limited objection on the grounds that some of the alleged conduct did not give rise to a colorable claim. Of significance here is that the debtors argued that there was no cause of action for deepening insolvency.²³ The United States Bankruptcy Court for the Northern District of Ohio overruled that objection.

In considering the viability of deepening insolvency as a free-standing tort, the *LTV* court placed significant reliance upon *Lafferty* and upon the *LTV* court’s perception that there was a “growing list of jurisdictions recognizing this doctrine.”²⁴ After discussing *Lafferty*, the court cited six other cases it claimed had accepted what the *LTV* court described as the “deepening insolvency theory of director and officer liability.”²⁵ The court also noted that debtor *LTV Steel* was a New Jersey corporation and debtor *LTV Corporation* was a Delaware corporation, and that both New Jersey and Delaware are in the Third Circuit. Consequently, the court concluded that deepening insolvency is a colorable claim.²⁶

In re VarTec Telecom, Inc.

The observation in *LTV* that there has been a “growing acceptance” of the deepening insolvency theory as a stand-alone tort may be premature. It is noteworthy that nowhere in *LTV* does the court discuss *Global Service*, which was decided a year before the decision

21 *Id.* citing *Lafferty*, 267 F.3d at 358-59 (punctuation by *Total Containment* court). This is referred to as the “adverse interest exception” to the *in pari delicto* defense.

22 *Id.* at 622.

23 333 B.R. at 421. One of the proposed defendants made the same argument in his own objection to the motion of the ACC.

24 *Id.*

25 *Id.* In addition to *Lafferty*, the *LTV* court cited *Florida Dep’t of Ins. v. Chase Bank of Texas Nat’l Ass’n*, 274 F.3d 924, 935 (5th Cir. 2001), *In re Computer Personalities Sys., Inc.*, No. 01-14231, 2003 WL 22844863 (Bankr. E.D. Pa. Nov. 18, 2003), *Robertson v. White*, 633 F. Supp. 954, 960-78 (W.D. Ark. 1986), *In re Gouiran Holdings, Inc.*, 165 B.R. 104, 106-08 (E.D.N.Y. 1994), *In re Exide Techs., Inc.*, 299 B.R. 732, 736 (Bankr. D. Del. 2003), *Marwil v. Grubbs*, No. 1:03-cv-1165, 2004 WL 2278751, at *3, 5, 2004 US Dist. LEXIS 20250, at *13, 18-19 (S.D. Ind., Sept. 30, 2004).

26 333 B.R. at 429.

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in *LTV* was issued. Other courts have been far more approving of *Global Service* and its reasoning.

In *In re VarTec Telecom, Inc.*, 335 B.R. 631 (Bankr. N.D. Tex. 2005), the United States Bankruptcy Court for the Northern District of Texas discussed *Global Service* and the evolution of the theory of deepening insolvency at length. It noted the accepted origin of the theory in *Bloor v. Danskere (In re Investors Funding Corp of New York Sec. Litig.)*, 523 F. Supp. 533 (S.D.N.Y. 1980), and traced the development of the theory, in part through the analysis done in *Global Service*. The *VarTec* court acknowledged, as did the Third Circuit in *Lafferty*, that no cause of action for deepening insolvency appears in the Bankruptcy Code, nor is it otherwise a creature of other federal law. Therefore, in order to determine if deepening insolvency is an actionable tort, the court had to determine how applicable state law would treat the claim; in the *VarTec* case, that meant the court would look to Texas law.²⁷

In attempting to predict whether Texas would recognize deepening insolvency as a separate cause of action, the court began²⁸ with a review of the decisions of the Texas Supreme Court. Since there was no Texas Supreme Court decision explicitly identifying deepening insolvency as a separate tort, it next considered the rationales underlying Texas Supreme Court decisions considering recognition of a new tort. In response to the committee's argument à la *Lafferty* that Texas courts adhere to the principle that "a remedy is provided for every

legal wrong," the *VarTec* court noted that the Texas Supreme Court is "not keen on recognizing new torts, and 'treads cautiously in this area.'"²⁹ The court also cited with approval the analysis in *Global Service* of "[w]hether 'deepening insolvency' is either a theory of damages and not a tort at all, or whether the damages recoverable are substantially duplicated by other torts."³⁰ The *VarTec* court, not particularly persuaded by the reasoning in *Lafferty*, stated that:

Lafferty was ultimately a fraud case where deepening insolvency of the corporation could have been considered as part of the breach of the officers' and directors' fiduciary duties owed to the corporation with resulting damages.³¹

Based on its review of the decisions and analogous Texas law, the *VarTec* court concluded that:

[T]he Texas Supreme Court would not adopt "deepening insolvency" as a separate tort, because the injury caused by the deepening of a corporation's insolvency is substantially duplicated by torts already established in Texas. [Footnote omitted.] Further, as the case law in this area has shown, for a plaintiff to assert a valid claim for damages under a theory of "deepening insolvency" the plaintiff must show that the defendant has committed some other tort.³²

VarTec therefore joined *Global Service* in rejecting a stand-alone tort of "deepening insolvency.

²⁷ 335 B.R. at 639. Before examining whether Texas would recognize deepening insolvency as a separate cause of action, the *VarTec* court conducted its own "headcount" of decisions that rejected deepening insolvency as an independent tort and noted that the *Global Service* court found that the majority of federal courts to consider the matter have treated deepening insolvency either as a theory of damages or have raised serious questions about its viability. The decisions listed by the *VarTec* court in this camp include *In re Global Serv. Group LLC*, 316 B.R. 451 (Bankr. S.D.N.Y. 2004), *Hannover Corp. of America v. Beckner*, 211 B.R. 849, 854 (M.D. La. 1997), *Allard v. Arthur Anderson & Co. (USA)*, 924 F. Supp. 488, 494 (S.D.N.Y. 1996), *Drabkin v. L&L Constr. Assocs., Inc. (In re Latin Inv. Corp.)*, 168 B.R. 1, 6 (Bankr. D.D.C. 1993), *Florida Dep't of Ins. v. Chase Bank of Texas Nat'l Ass'n*, 274 F.3d 924, 935-36 (5th Cir. 2001) (questioning whether Texas would recognize the cause of action), *Askanase v. Fatjo*, No. Civ. A. H-91-3140, 1996 WL 33373364, at *28 (S.D. Tex. Apr. 1, 1996), *Feltman v. Prudential Bache Sec.*, 122 B.R. 466, 473-74 (S.D. Fla. 1990), *In re Greater Se. Cmty Hosp. Corp.*, 333 B.R. 506, 517-18 (Bankr. D.D.C. 2005), *In re Parmalat*, 383 F. Supp. 2d 587 (S.D.N.Y. 2005).

²⁸ 335 B.R. at 641-42 citing *Centennial Ins. Co. v. Ryder Truck Rental Inc.*, 149 F.3d 378, 382 (5th Cir. 1998).

²⁹ *Id.* at 642 citing *Trevino v. Ortega*, 969 S.W.2d 950, 951 (Tex. 1998).

³⁰ *Id.* at 642.

³¹ *Id.* at 643.

³² *Id.* at 644.

Conclusion

The weaknesses of the deepening insolvency theory of liability have been ably pointed out by *Global Service* and more recently *VarTec*. In fact, even those decisions that purport to disagree with the result in *Global Service* and *VarTec* tacitly recognize that the theory is duplicative of other causes of action that already exist. This is evident from the limitations placed on the utility of the theory by defenses such as the *in pari delicto*

doctrine and the requirement that fraud be alleged in order to state a claim for deepening insolvency. In all likelihood, unless and until the theory is tested at a stage of the proceedings after a motion to dismiss, it will be difficult to predict whether the independent tort of deepening insolvency has any utility at all, even in those jurisdictions that do not recognize it for what it is: an unnecessary and duplicative cause of action that does nothing to increase the recovery for creditors over the existing tools that are already available.

Second Circuit Revisits Role of International Comity Involving Foreign Proceedings

In *JPMorgan Chase Bank v. Altos Hornos de Mexico, S.A. de C.V.*, 412 F.3d 418 (2d Cir. 2005), the United States Court of Appeals for the Second Circuit reaffirmed its long-standing rule, first set forth in *Koreag, Controle et Revision S.A. v. Refco F/X Assocs. Inc.*, 961 F.2d 341, 349-50 (2d Cir. 1992), that US courts do not owe comity to foreign bankruptcy proceedings in connection with disputes regarding the ownership of a foreign debtor's US assets. In so doing, the Second Circuit took the opportunity to explore the foundations of international comity and to explain the scope of the so-called "Koreag exception" to the general rule that US courts should ordinarily decline to adjudicate creditor claims that are the subject of a foreign bankruptcy proceeding, "so long as the foreign proceedings are procedurally fair and... do not contravene the laws or the public policy of the United States." *Altos Hornos*, 412 F.3d at 424 citing *Cunard S.S. Co. Ltd. v. Salen Reefer Servs. AB*, 773 F.2d 452, 457-59 (2d Cir. 1985).

Background

The *Altos Hornos* case arose when Altos Hornos de Mexico S.A. de C.V. ("Altos Hornos") filed a Mexican bankruptcy proceeding in 1999 (the "Mexican Proceeding"). At the time the Mexican Proceeding was filed, Altos Hornos owed a syndicate of banks, led by JPMorgan, approximately \$225 million (the "Loan"). Under the terms of the documentation pertaining to the Loan, a collection account was established in the name of JPMorgan at JPMorgan, from which JPMorgan had the exclusive right to make withdrawals for the following three limited purposes (1) to reimburse itself for fees and expenses, (2) to make payments on account of the Loan, and (3) after the Loan was paid off, to deliver any surplus funds

to Altos Hornos. In separate documentation, Altos Hornos assigned its rights to receive payment from three specific customers (the "Customers") to JPMorgan for deposit into the collection account. In 1999, after Altos had filed the Mexican Proceeding, the Customers made \$4.7 million of payments into the Collection Account. JPMorgan used \$880,708 to pay legal fees, but otherwise made no payments to itself or the bank syndicate from the Collection Account.

The Mexican Proceedings

Shortly after the Mexican *suspension de pagos* ("suspension of payments" or "SOP") proceedings were commenced in May, 1999 by Altos Hornos in a Mexican civil court (the "Mexican Court"), JPMorgan appeared before the Mexican Court to have the amount of the bank consortium's claim acknowledged and to have that claim determined to be a secured claim based upon the banks' rights in the Collection Account. The Mexican Court did acknowledge the consortium's claims, but it ruled that JPMorgan and the rest of the banks were merely unsecured creditors, because the agreement whereby Altos Hornos caused the Customers to make payments directly to the collection account was an "assignment" rather than "collateral" and under Mexican law that arrangement did not qualify the banks as secured creditors. Both parties appealed: Altos Hornos from the acknowledgement of the banks' claims, and JPMorgan from the determination that it was not a secured creditor under Mexican law. Both appeals were denied by the Mexican appellate court in February, 2004, and JPMorgan appealed again to the Mexican federal court. In the meantime,¹ JPMorgan determined it would take

¹ Altos Hornos was similarly not satisfied with awaiting the outcome of the Mexican appeals. In December of 2002, Altos Hornos petitioned the Mexican Court to (1) summon JPMorgan to release the funds in the Collection Account to Altos Hornos based on the ruling on appeal that the funds in the Collection Account were not collateral for the Loan, and (2) to issue a letter rogatory to a New York court to enforce that summons. JPMorgan opposed the request based on the argument that the Mexican Court lacked jurisdiction to consider the petition. The Mexican Court deferred making a decision on the request of Altos Hornos pending a decision on the appeals and therefore did not address the issue of jurisdiction raised by JPMorgan nor the question of ownership of the assets in the Collection Account.

action in the United States. It is that litigation that ultimately came before the Second Circuit.

Commencement of the US Proceedings

In March of 2003, JPMorgan sued Altos in the United States District Court for the Southern District of New York (the “District Court”) seeking a declaration that it (and not Altos Hornos) owned the funds in the Collection Account. Altos Hornos moved to dismiss this action (the “New York Action”), arguing that principles of international comity weighed in favor of obliging the District Court to abstain from deciding the questions raised by JPMorgan and to defer to the proceedings pending in Mexico. The District Court granted the motion of Altos Hornos, finding (a) that the issue of who owns the Collection Account was implicitly raised by Altos Hornos before the Mexican Court and Mexican law does not dictate where that dispute must be decided, (b) that the choice of law and forum selection clauses in the Loan documentation (both opting for New York) “would not control where international comity warranted abstention,” and (c) that because the issue was raised before the Mexican Court and that court had jurisdiction to decide the issue, “international comity required the district court to abstain and allow the issue to be resolved in the Mexican proceedings.” The District Court dismissed the New York Action. JPMorgan appealed.

Second Circuit’s Analysis of Scope of International Comity Principles

Before considering the weaknesses of the District Court decision below, the Second Circuit spent some time exploring the origins and purpose behind international comity. It began with the decision of the United States Supreme Court in *Hilton v. Guyot*, 159 US 113, 164 (1895), in which the Supreme Court explained that international comity consists of:

the recognition which one nation allows within its territory to the legislative, executive or judicial

acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.

In analyzing the history of international comity, the Second Circuit cited a number of authorities to the effect that international comity is “‘an imperfect obligation’ that ‘cannot be reduced to any certain rule.’” 413 F.3d at 423 (citations omitted). Nevertheless, at least in the Second Circuit, where issues of international comity are implicated, a general rule has emerged that US courts should ordinarily decline to adjudicate creditor claims that are the subject of a foreign bankruptcy proceeding. This is seen as being necessary in order to facilitate the equitable and orderly distribution of the debtor’s assets among creditors holding valid claims. The Second Circuit explained that deference to the foreign court is appropriate provided the foreign proceedings are procedurally fair and “do not contravene the laws or public policy of the United States.” 412 F.3d at 424 *citing Cunard*, 773 F.2d at 457-59.

The *Koreag* Exception

Having established the general rule, the Second Circuit then turned to the “limited exception” to that rule identified in *Koreag*, 961 F.2d at 349-50. The so-called “*Koreag* Exception” provides, in essence, that where questions of ownership of an asset arise, those property interests raise threshold issues that should be determined by local law and are independent of the distributive rules that apply in foreign proceedings that should be accorded comity by US courts. In other words, where a creditor which brings an action in a US court is “not asserting rights like a creditor in a bankruptcy proceeding, but rather [is] asserting that [the debtor] did not own the disputed [asset]... [the claim of the creditor is] ‘antecedent to the distributive rules of bankruptcy administration’ and thus properly adjudicated in a US court.” *Altos Hornos*, 412 F.3d 425 *citing Koreag*, 961 F.2d at 349.

Second Circuit's Review of the District Court Decision

Although the Second Circuit ultimately affirmed² the result reached by the District Court in choosing to abstain from hearing the case brought by JPMorgan, it rejected the District Court's application of the principles of international comity and the *Koreag* exception.

In reaching its decision to abstain, the District Court relied heavily on a distinction drawn by the *Koreag* court between the language set forth in section 304(b)(2) of the Bankruptcy Code,³ which provides that a bankruptcy court may order turnover of property *belonging to a foreign debtor's estate*, and the language set forth in section 304(b)(1) of the Bankruptcy Code, which allows a US court to enjoin actions against property *involved in a foreign bankruptcy proceeding*. In *Koreag*, the Second Circuit had noted that the language in section 304(b)(1) was much broader than the language in section 304(b)(2), and, that therefore, a debtor had to establish its ownership rights more conclusively in the context of a turnover action under section 304(b)(2) than in the context of a request for injunctive relief under section 304(b)(1). See *Altos Hornos*, 412 F.3d at 425. The District Court indicated that, because standard for determining property rights was more relaxed under Section 304(b)(1), the *Koreag* exception to granting comity was only applicable to turnover requests pursuant to section 304(b)(2) of the Bankruptcy Code and was not applicable to requests for injunctive relief. The District Court then reasoned that the request of Altos Hornos to dismiss the New York Action was tantamount to an injunction, rendering the *Koreag* exception inapplicable. The Second Circuit rejected this application of *Koreag* to the dispute between

JPMorgan and Altos Hornos as presented in the New York Action. *Altos Hornos*, 412 F.3d at 425-426.

First, the Second Circuit noted that the New York Action did not involve *either* section 304(b)(1) or section 304(b)(2) of the Bankruptcy Code. *Altos Hornos*, 412 F.3d at 425. Accordingly, the District Court's reliance on the language of statutes that were inapplicable constituted error. Next, the Second Circuit noted that the request of Altos Hornos to dismiss the New York Action was not tantamount to a request for injunctive relief and that the District Court erred in equating a request for dismissal with a request for injunctive relief. *Id.* The Second Circuit also pointed out that *Koreag* did not hold that federal courts are barred from determining ownership in a section 304(b)(1) proceeding; merely that such a determination was less relevant under section 304(b)(1) because that section covers property "involved in" a foreign bankruptcy proceeding, which is not strictly limited to the debtor's estate. *Altos Hornos*, 412 F.3d at 426. In summary, the Second Circuit clarified the *Koreag* exception, stating that

Bona fide questions of property ownership—whether or not raised in a § 304(b)(2) turnover action—are antecedent to the distributive rules of bankruptcy administration because they seek to determine whether an asset is actually part of the debtor's estate, rather than deciding the entitlement of certain creditors to pieces of that estate. Property ownership questions thus precede distribution and, for the reasons stated in *Koreag*, are best resolved under local law. *Id.*

As a result, the Second Circuit reaffirmed *Koreag* and reiterated that US courts may resolve bona fide questions of property ownership arising under

2 In its decision, the Second Circuit pointed out that on January 27, 2005—that is, after the appeal before the Second Circuit was argued but before the decision was rendered—the Mexican federal court reversed the decision of the lower Mexican courts and ruled that the consortium banks were secured creditors. In footnote 1 of the opinion, the court expressed its displeasure that the banks waited nearly two months to inform the Second Circuit of that judgment. Accordingly, it denied the motion brought by JPMorgan to voluntarily dismiss its appeal.

3 11 U.S.C. § 304 has been replaced by chapter 15 of the Bankruptcy Code in connection with cases filed after October 17, 2005.

local law without deferring to a pending foreign proceeding. The trouble for JPMorgan was that the Second Circuit found that there was no *bona fide* question of property ownership and, therefore, the District Court acted properly in choosing to abstain from hearing the New York Action on the grounds of international comity.

Application of *Koreag* and *Altos Hornos* to Chapter 15

The *Altos Hornos* court explicitly noted that the drafters of section 304 of the Bankruptcy Code did not intend to overrule “well-established principles based on considerations of international comity” applicable in foreign bankruptcies. 412 F. 3d 425, n. 2 citing *Cunard*, *supra*, 773 F.2d at 456. Now that section 304 has been replaced by new chapter 15⁴ of the Bankruptcy Code, it will be left to another court to determine the scope of these well-established principles of international comity and the applicability of the *Koreag* exception in chapter 15 proceedings. While chapter 15 is a relatively new statute and its scope is unclear, certain provisions of chapter 15 would appear to limit or supersede the *Koreag* exception, as reaffirmed in *Altos Hornos*. For example, section 1525 of the Bankruptcy Code provides that “[c]onsistent with

section 1501, the court shall cooperate to the *maximum extent possible* with a foreign court or a foreign representative, either directly or through the trustee.” (Emphasis added). This broad language could be interpreted to oblige a US court handling a chapter 15 case to defer to proceedings in a foreign court, even in connection with questions regarding ownership of estate assets.

We do not believe that any limitation on the *Koreag* exception was intended by the drafters of chapter 15 despite the sweeping language in section 1525. Certainly, many provisions of chapter 15 appear to counsel great deference to foreign courts. For example, chapter 15 authorizes a US court upon “recognition” of a “foreign main proceeding,”⁵ to grant broad relief to a foreign representative (*see, e.g.*, 11 U.S.C. §1521(a)), and to “entrust the distribution of all or part of the debtor’s assets located in the United States to the foreign representative or another person” if the court determines that “the interests of creditors in the United States are sufficiently protected” (11 U.S.C. §1521(b)). Yet, nothing in new chapter 15 would seem to require that US courts must defer to foreign courts where the antecedent question of what assets are actually owned by the debtor are at issue. The *Koreag* exception, as amplified by *Altos Hornos*, should continue to have efficacy despite the enactment of chapter 15.

4 Chapter 15 went into effect on October 17, 2005, and creates a comprehensive scheme for cross-border insolvency proceedings that replaces the “ancillary proceeding” previously available under section 304 of the Bankruptcy Code, the section of the Bankruptcy Code at issue in *Koreag*.

5 A “foreign main proceeding” is a foreign bankruptcy proceeding pending in the county where the debtor has the center of its main interests. The debtor’s representative in a foreign main proceeding has extensive rights under chapter 15, including the right to use property of a debtor’s estate within the United States as permitted by section 363 of the Bankruptcy Code.

Germany's *Insolvenzordnung* has yet to fulfill its Promise of Facilitating Widespread Usage of Plans of Reorganization

On January 1, 1999, Germany's new Insolvency Law ("*Insolvenzordnung*" or "*InsO*") took effect. The key innovation in the InsO was the creation of an opportunity for a debtor to be reorganized pursuant to a plan of reorganization under provisions modeled on chapter 11 of the United States Bankruptcy Code. Until the InsO, the only method of "reorganizing" a bankrupt entity was by liquidating the insolvent entity's assets through what was (and is) known as an "asset deal"¹ in order to generate proceeds to pay creditors.

Although "reorganization" may still take place pursuant to the "asset deal" and without a plan, the InsO offers the potential of preserving a debtor's going concern value by allowing the debtor to remain in business after confirmation of a plan of reorganization ("*Insolvenzplan*"). By allowing the debtor to remain in business, the InsO promotes the goal of making greater distributions available to creditors than would be the case under straight liquidation. In addition, plans of reorganization under the InsO could be

attractive because distributions to creditors under an approved plan may be made in a manner other than according to the general distribution scheme that applies absent a plan in an asset deal.

Despite the promise of the InsO, relatively few plans of reorganization have been proposed under the new law. Insolvency administrators, creditors and debtors remain reluctant to resort to the plan process contemplated by the InsO, continuing to prefer the traditional asset deal as the method for reorganizing the debtor. This reluctance is reinforced by the shortage of case law² interpreting the new InsO and explaining the requirements for plan confirmation. Although courts are obtaining additional opportunities³ to rule upon the plan requirements of the InsO as additional cases are filed, it is unlikely that the plan process will find broad usage in German insolvency cases, at least until some track record of success is established.⁴ The problem is the perception, not completely

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- 1 In an "asset deal," an insolvent business is "reorganized" by transferring the assets of the debtor that are necessary to operate the business to a third party, and the claims of the creditors of the debtor are then satisfied from the proceeds of the transfer. This transfer can occur without the approval of a plan of reorganization.
 - 2 In fact, it was not until March 2005 that the German Federal Court of Justice interpreted the scope of a creditor's right to equal treatment under a plan of reorganization under the InsO. As was discussed in greater detail in the September 2005 issue of *Insolvency Notes*, in March, 2005, the Court determined that a plan of reorganization could not be confirmed where a creditor purchased some, but not all, of the claims of creditors in a particular class at a premium in order to vote those claims to accept the plan. The Court found that this device was inequitable pursuant to section 250 No. 2 of the InsO, as it violated the principles set forth in section 226(1) of the InsO which requires that all creditors within a class be treated equally, section 226(2) which prohibits discrimination among creditors within a class unless all affected creditors consent, and section 226(3) which prohibits any entity from entering into agreements with a creditor pursuant to which the creditor will be provided with an advantage in return for voting or acting in a certain manner in an insolvency proceeding. (German Federal Court of Justice decision of 3 March 2005, reference IX ZB 153/04).
 - 3 Shortly after its decision of March 3, 2005, the German Federal Court of Justice had another opportunity to deal with a plan-related appeal, ruling on the material limitations for forming so-called "mixed" creditor classes with both secured and unsecured claims (German Federal Court of Justice, decision of 7 July 2005, reference IX ZB 266/04). In this decision, the German Federal Court of Justice held that the value of a lien held by a secured creditor—and thereby the amount of such creditor's secured claim—was to be based on a going concern valuation, rather than the nominal value of the lien at the time of plan confirmation. If this were not the case, then the creditor would be holding a partially unsecured claim and the plan would have improperly classified a secured creditor and an unsecured creditor in the same class in violation of section 222 of the InsO, rendering the plan unconfirmable. The Court reasoned, however, that because the plan of reorganization stipulated a continuation of the business, legislative history supported valuation of the lien using going concern values. The case was therefore remanded to the lower court for further findings of fact.
 - 4 The recent restructuring of the *Ihr Platz* chain of drug stores may be a beginning. In early 2005, Goldman Sachs Group Inc. and a group of other investors bought \$144 million of bank debt owed by *Ihr Platz*, hired a team of turnaround experts to run the company, and caused the company to file for bankruptcy relief in May of 2005. Eight months later, *Ihr Platz* was reorganized under a plan of reorganization approved under the InsO in what may be the first successful self-administered insolvency in Germany.

unjustified, that the InsO contains too many hurdles to plan confirmation and too much uncertainty to justify the delay and expense associated with pursuing a plan as opposed to reorganizing through an asset deal.

Understanding the impediments to widespread acceptance of the plan process under the InsO begins with consideration of the policies and principles underlying German insolvency law. Thereafter, one can turn to the specific statutory requirements that must be met under the InsO to confirm a plan to discover the bases for the resistance to using the plan process in Germany. Ultimately, only experience and a favorable judicial track record will increase the number of reorganizations that are effectuated using plans of reorganization, but until certain veto powers are removed, it is unlikely that use of such plans will ever outpace the use of the asset deal in German reorganizations.

The Policies and Principles Underlying Insolvency Law in Germany

A pivotal difference between bankruptcy law in the United States and insolvency law in Germany is one of policy. In the United States, success in bankruptcy is measured by the rehabilitation of the debtor; achieving the so-called “fresh start.” In Germany, success in bankruptcy is measured by the payment of creditors. This distinction lays at the root of some of the differences between chapter 11 and the InsO and explains, in part, why plans of reorganization have remained the exception rather than the rule in German insolvency proceedings. Additionally, understanding that distinction provides

some insight into how the German legislature chose to balance the following principles in enacting the provisions in the InsO that govern plans of reorganization:

- (i) the principle that debtors should be given the opportunity to reorganize without being liquidated;
- (ii) the principle that individual creditors’ interests and rights to receive payment should be protected;
- (iii) the *pareto optimum* principle (see below);
- (iv) the principle of “creditor autonomy” (see below); and
- (v) the *par conditio creditorum* principle (see below).

The latter three principles, though they may sound unfamiliar to practitioners in the United States, are also themes found in chapter 11 in the United States. The *pareto optimum* principle refers to limits on the reallocation and use of the debtor’s assets that are enacted to ensure that, if the plan reallocates the debtor’s assets among creditors as compared to straight liquidation, such reallocation is accomplished without making any individual non-consenting creditor worse off than it would be in straight liquidation while benefiting at least one creditor.⁵

The principle of creditor autonomy or creditor independence refers to the concept in German insolvency law that all major decisions in the insolvency proceedings are to be made and/or approved by the creditors. This principle underlies the right granted to the creditors by the InsO to determine whether the debtor should be liquidated or reorganized.⁶ It is also the principle that underlies the requirement that, in order for

⁵ Under United States law, this principle finds expression in the “best interests of creditors’ test” which bars a court from confirming a plan if any objecting creditor receives less than it would in a chapter 7 liquidation case. 11 U.S.C. §1129(a)(7).

⁶ The decision which alternative to pursue is typically made some three to five months after the filing of the petition at the time the bankruptcy administrator makes his or her report on the debtor’s business situation and the events that led to the insolvency. In practice, the manner in which debtor and/or preliminary insolvency administrator conduct business in preliminary proceedings will be decisive in determining whether there is a chance for reorganization.

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a plan to be confirmed by the court when fewer than all the classes vote to accept the plan (*i.e.*, Germany's form of "cram down"), it is still necessary that a *majority* of the classes of creditors vote to accept the plan.⁷

The *par conditio creditorum* satisfaction principle is the principle of equal treatment among creditors. This principle is what underlies, for example, the prohibitions on discriminating among creditors within a class unless all affected creditors give their consent.

Understanding the foregoing principles provides a reference point for how the German legislature chose to import the plan process into the InsO, and it also aids in predicting how courts are likely to interpret the provisions of the InsO governing reorganization using a plan of reorganization. Greater predictability will result in wider acceptance of the plan process but, as is discussed below, some of the provisions of the InsO are likely to continue to induce parties to elect the asset deal instead of proceeding with a plan.

The Mechanics of Confirming a Plan Under the German InsO

The process of approval and confirmation of plans of reorganization under the InsO bears some resemblance to chapter 11 proceedings. Plan confirmation involves drafting and proposing a plan, obtaining the requisite creditor approvals, seeking to invoke "cram down" if fewer than all of the creditor classes vote to approve the plan, meeting

other conditions for confirmation, and obtaining a court order approving the plan. However, beyond the superficial similarities with chapter 11, there are some key differences which may ultimately curtail the widespread use of plans of reorganization to reorganize debtors in Germany.

a. Preparation and Submission of the Plan

Under German law, both the insolvency administrator⁸ and the debtor are authorized to submit a plan of reorganization.⁹ By statute, the proposed plan must contain details of the debtor's intended reorganization¹⁰ and the measures to be taken to achieve these ends. By statute, the plan must contain various statements regarding, *inter alia*, the estate, the debtor's business, the debtor's financial condition and the nature of its liabilities. The plan should also contain information that will help persuade the creditors and the court of its feasibility and benefits vis-à-vis straight liquidation.

More specifically, a plan of reorganization in Germany consists of two parts: the factual part, which describes the debtor, its business, and how its financial condition deteriorated to bring it into an insolvency proceeding, and the "constitutive" part which explains how the legal rights of creditors will be modified by the plan, what the sources of payments to creditors will be, and how creditors will be paid (in full, over time, etc.).

Upon submission of the plan, the court will undertake an initial review of the plan. At this stage, the court considers whether the plan conforms to the general formal guidelines contemplated by the InsO and

7 This is a significant departure from voting in chapter 11. While in Germany, cram down requires a majority of the creditor classes vote in favor of the plan, in the United States, only one impaired class must vote in favor of the plan to preserve its eligibility for cram down. 11 U.S.C. §1129(a)(10) & §1129(b).

8 As was noted above, it is the creditor body which determines whether the debtor will be reorganized by way of an asset deal (straight liquidation) or by way of a plan of reorganization and this decision is ordinarily made some 3 months after the case is commenced. However, in the rare cases where the debtor's management remains in control ("*Eigenverwaltung*"), only the debtor has an original right to submit a plan and often this is done simultaneously with the filing of the petition as a "pre-packaged plan." The mandatory examiner ("*Sachwalter*") appointed in cases where the debtor's management remains in control only has the right to submit a plan if he or she is instructed to do so by the general creditors' meeting.

9 The plan can be filed simultaneously with the bankruptcy filing as a pre-packaged plan. This right is only afforded to the debtor and not the administrator.

10 Theoretically, a plan of reorganization can also be used to liquidate a corporate debtor, but from a practical standpoint such use seems—at best—limited.

whether the proposed distributions are obviously infeasible. It may also review whether the claims have been classified in a manner consistent with the InsO.¹¹ This is something of a challenge because the InsO offers little more guidance than that claims in a class must be similar to one another. Nevertheless, the InsO contemplates eight general “groups” or classes of creditors composed of the following types of claims, listed in order of seniority: (i) secured claims that are impaired in some way by the plan¹² (such as by extending the period for repayment, etc.), (ii) general unsecured claims, (iii) claims for “pendency interest,” meaning post-petition interest on unsecured claims, (iv) claims for reimbursement of the costs incurred in participating in the proceedings, (v) fines and fees owed to the state (but not taxes, as they are considered general unsecured claims), (vi) claims for performance by the debtor without remuneration (e.g., the debtor has promised certain parts of the estate to someone as a gift), (vii) shareholders’ equitably subordinated claims, and (viii) claims that have been contractually subordinated. The last six classes of creditors are collectively referred to as the subordinated classes, because they are junior in priority to the general unsecured creditors’ class. Each of those subordinated classes is treated as a class if and only if the plan of reorganization stipulates some recovery for them; if not, these subordinated claims—with the exception of fines and fees owed to the state—are deemed to be discharged¹³ after plan confirmation and do not constitute a voting class. Each of these eight types of claims (secured, unsecured and six types of subordinated) are considered, as among the members of such classes,

to encompass “claims having the same legal status” for the purposes of plan proceedings and represent the primary classifications for voting purposes. Within each type of claim, the debtor or administrator filing the plan may create further sub-classes of claims that are substantially similar.¹⁴ Such classes are wholly independent for voting and cram-down purposes. For example, a plan may contemplate one class of secured claims and four separate classes of general unsecured claims. All five groups would vote on the plan, and, if fewer than all classes accept the plan, three of these groups would have to reach the requisite majorities in order for the cram-down provisions to be available.

If the plan fails to meet the fundamental criteria for an acceptable plan contained in the InsO, the plan will be rejected by the court before it even reaches the creditors. In addition, the court may reject the plan *sua sponte* if the court determines that there is no chance that the plan will be accepted by creditors. If the court determines there are no fundamental flaws in the plan, the plan is then brought for a vote at a general creditors’ meeting.

b. Creditor Approval of the Plan

Ultimately, the question of whether a proposed plan can actually be used to reorganize the debtor’s business and preserve its going concern value will depend upon creditor approval, which is determined through a vote at the creditors’ meeting. The rights of the creditors at the creditors’ meeting to vote on the plan of reorganization are determined on the basis of the claims that have been

11 Whether or not this is the appropriate stage to scrutinize whether improper gerrymandering has occurred is currently a topic for debate in academic publications.

12 In the absence of a plan, secured creditors will be able to take control of their collateral (or have their collateral sold and the proceeds distributed to them by the insolvency administrator) and have any remaining claim treated as a general unsecured claim.

13 In fact, in most cases it is highly likely that the claims in the subordinated classes will be discharged and so they are rarely able to vote on reorganization plans.

14 German law allows for further claim classification under each type based on reasonable business similarity of the claims. For example, the individual creditors’ business interests could be differentiated between those having an interest in continued business with the reorganized debtor based on a long-standing business relationship and those “merely” interested in recovery of their claim. In addition, the InsO explicitly stipulates that employees’ claims “should” be grouped together. They do not, however, form a separate type of claim and can also be grouped with other general creditors’ claims for voting purposes.

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registered in insolvency proceedings. A “registered” claim is a claim that is duly filed and not disputed by the administrator or another creditor. In other words, only undisputed claims confer voting rights upon the creditor holding the claim.¹⁵ In addition, if the undisputed claim is not impaired in any way by the plan, there is no right to vote; holders of unimpaired claims do not vote.¹⁶ In addition, creditors that have a right under German law to the segregation of assets, meaning that the assets are property of the creditor and not the property of the debtor, such as in the case of conditional sales of goods under German law, are not accorded voting rights.

At the creditors’ meeting, each class of claims, as established by the plan, votes on the plan separately. A class votes to accept a plan when the majority of the creditors in that class, determined by majority in number and by majority in claim amount, votes to accept the plan. In order to confirm the plan in the absence of the German equivalent of “cram down,” all classes must vote to accept the plan.

c. Cram-Down Under the InsO

In the event that not all of the classes vote to accept the plan, the plan may nevertheless be confirmed if the “cram down” requirements under the InsO are met. To be eligible for cram-down under the InsO, the majority¹⁷ of the classes voting must approve the plan. In addition, other conditions must be met, including tests similar to the “best interests of creditors test” and the absolute priority rule codified in section 1129(a)(7) of the Bankruptcy Code. In addition, the debtor must have approved the plan. However, the debtor is generally deemed to have approved the

plan if the debtor does not object to it. Furthermore, objections by the debtor are disregarded if the debtor does not receive less than the debtor would receive without the plan and no creditor receives more than the full amount of its claim.

If the requisite majorities are met and the debtor’s approval has been obtained or is deemed to have been obtained, the plan will be confirmed unless the court determines that acceptance of the plan was obtained in an inequitable manner or if the court determines that other confirmation requirements are not met as may be claimed by creditors (or shareholders, as is discussed below). One example of inequitably obtaining acceptance of the plan is for the plan proponent to provide one or more creditors with preferential treatment, as was found to be the case by the German Federal Court of Justice in the case discussed above.¹⁸ If the court has not already addressed the issue of gerrymandering in its preliminary scrutiny of the plan, it will address the issue in connection with the appropriateness of cram down.

d. Other Impediments to Cram Down

In addition to its independent review of the plan and whether the confirmation requirements have been met, the court will also consider confirmation objections raised by creditors.¹⁹ Principal among these objections is that the creditor will receive less under the plan than it would receive in liquidation proceedings. Another area where a plan may be fatally flawed is if the plan fails to give any dissenting class of creditors an equitable share of the economic

¹⁵ Notwithstanding this general rule, creditors holding disputed claims may receive voting rights if and to the extent the administrator and the other creditors present at the creditor’s meeting agree to grant the creditor holding a disputed claim voting rights.

¹⁶ Secured creditors do not receive voting rights if they are fully secured and their claim is not impaired with regard to the collateral. However, if the plan is being used as a restructuring instrument, a secured creditor’s rights will often be impaired in some manner (*e.g.*, continuation or roll-over on a credit facility to generate short-term liquidity) and in such circumstances do have the right to vote on the plan.

¹⁷ This requirement probably explains why in Germany there are rarely more than the traditional secured and unsecured classes of creditors; if a majority of the creditor classes must vote to accept a plan in order to be eligible for cram down, the incentive will be for fewer classes. In the United States, where only one impaired class must vote in favor of the plan to qualify for cram down, the inclination is exactly the opposite: to multiply classes of creditors.

¹⁸ See Note 2 above and Insolvency Notes, September 2005, at page 6.

¹⁹ Based on the legislative record on this issue, it appears that any creditor—not just those with voting rights—can invoke this right to challenge the plan.

value arising from proceeding via a plan as opposed to an asset deal. This objection may be overcome if (i) no class receives recovery in excess of its claim, (ii) neither the debtor nor creditors with subordinate claims receive any recovery, and (iii) no creditor in another class, whose claim would otherwise rank with that of the class being crammed-down (“claims having the same legal status”), receives a premium or higher distribution than the recovery being offered to the dissenting class. German law therefore does not consider whether an “unfair discrimination” has taken place, as *any* discrimination will lead to the determination that the class would receive an inequitable share of the economic value accruing through the plan. This restriction on plan confirmation is based on the principle of recovery *par conditio creditorum*, which requires equal treatment of creditors in insolvency proceedings. As a result, the risk of plan rejection by the court increases if certain classes (even classes that would be considered a “convenience class” in US practice) were to receive full recovery when other unsecured creditors do not. In effect this means that if a plan were to pay a convenience class of creditors in full, the plan would be unlikely to be confirmed unless all creditor classes vote in favor of the plan.

e. Corporate Law Issues

Finally, any plan proceeding must take into account that the position of shareholders in German limited liability companies (*GmbH*) and stock corporations (*Aktiengesellschaften*) are not affected by the plan of reorganization. As is true under US law, shareholders are not creditors of the debtor under the InsO. Nevertheless, unlike under US law, there is no power to cancel the stock of existing equity and issue new stock to a new investor. German corporate law stipulates that the consent of existing shareholders is required if their shares are to be transferred to a third party as part of the plan of reorganization. If a

corporate debtor is to be reorganized and its business continued as a going concern, the vote of 75 percent or more²⁰ of the existing shareholders represented at the shareholders’ meeting to vote on the respective resolution may be required to make changes to the corporate structure and even continue the business as a going concern, regardless of whether the shareholders would receive a distribution in straight liquidation or not. This can lead to practical problems in gaining creditor approval when the company is hopelessly insolvent²¹ and equity is nonetheless effectively brought into the money to obtain its consent.

Shareholders of and partners in German debtors retain leverage in other ways as well. If a plan intends to permit a corporate or partnership debtor to reorganize and operate post-confirmation, it is necessary for the shareholders and/or partners, as the case may be, to issue a resolution to continue the business after confirmation of the plan. This presents both factual and legal problems for the insolvency administrator, the debtor and its creditors if equity does not wish to consent to a continuation of the business absent consideration for their cooperation. With partnerships where personal liability of the partners is a factor, there is a practical solution available because the plan can propose to exchange reduced liability of those partners for the requisite consents and resolutions. However, incentives of this nature are uncommon with regard to stock capital and limited liability corporations because these equity holders reason that they have nothing left to lose and nothing to gain from releases—because of the limited liability nature of the debtor’s corporate form—so they can extract value for themselves by refusing to cooperate with the plan, even if it means sabotaging restructuring efforts and effectively reducing the company’s net worth and thereby creditor recovery. This leverage, or the perceived potential that such leverage will be exercised, has the potential of stamping out any initial

²⁰ German corporate law requires that at least 75 percent of the shareholders represented at the shareholders’ meeting approve certain changes in corporate structure and similar actions, but the size of this super majority can be upwardly modified by the company’s articles of incorporation.

²¹ It should also be noted that insolvency is a prerequisite for filing for bankruptcy under German law. Although the InsO introduced “impending illiquidity” (*drohende Zahlungsunfähigkeit*) as grounds for filing, this has rarely been used in practice and also stipulates that the illiquidity is foreseeable and will more likely than not occur in the near future.

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interest creditors or the administrator may have in pursuing the plan of reorganization process in cases involving corporations or limited liability companies rather than an asset deal.

Conclusion

Some seven years after adoption of the InsO, plans of reorganization remain the exception and not the rule in bankruptcy proceedings in Germany. Indeed, in cases involving corporate and limited liability companies, resort to the plan process as opposed to the traditional asset deal is almost unheard of due to the leverage that equity holds in those cases as a matter of German corporate law. Nevertheless, despite some of the impediments to usage of a plan,

the flexibility of the plan process should improve the ability of debtors to reorganize and remain in business for the greater benefit of their employees and their creditors. Only experience will lead to the greater usage of the plan of reorganization in German bankruptcy cases. However, it is unlikely that the plan process will gain the widespread usage that is present in the United States due to the policy decisions behind the InsO that (a) require a majority of the creditor classes to approve the plan if any one creditor class votes against the plan, (b) prohibit any discrimination among creditor classes, and (c) allow equity to scuttle a plan if it is not given some incentive to support the plan. The uncertainties of plan confirmation will induce creditors and administrators to resort to that with which they are familiar: the asset deal.

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