

Client Alert

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Third Circuit Recognizes Australian Liquidation Proceeding of ABC Learning Centres as Foreign Main Proceeding Under Chapter 15

On August 27, 2013, in a case of first impression, the Third Circuit rejected an attack on a foreign liquidator's petition for recognition of an Australian insolvency proceeding under Chapter 15 of the US Bankruptcy Code premised on the argument that the foreign proceeding violated US public policy.¹

In so ruling, the Third Circuit followed the Second and Fifth Circuits in applying a narrow interpretation to the public policy exception to recognition of a foreign proceeding under Chapter 15. The decision is noteworthy because Australia's Corporations Act provides for parallel insolvency and receivership proceedings, which the Third Circuit acknowledged were predominately controlled in this case by a receiver serving the interests of secured creditors. Nonetheless, while Australian law provides a method of prioritizing creditors that differs from US law, the Third Circuit upheld the bankruptcy court's recognition of the Australian insolvency proceeding because it achieved similar goals.

This decision continues a line of cases narrowly interpreting the public policy exception of Bankruptcy Code §1506 and granting deference to foreign jurisdictions in determining how to prioritize claims of secured creditors. In the wake of the Third Circuit's decision, creditors seeking to oppose petitions for recognition of foreign proceedings should be prepared to draw fundamental distinctions between the law of the foreign jurisdiction and US law and policy beyond differing priority schemes.

Case Background

ABC Learning Centres Ltd. (the Debtor) was an Australian company that provided child care and educational services in Australia, the United States and other countries through various subsidiaries. In November 2008, projecting a \$1.78 billion loss for the 2008 financial year, the Debtor's directors voted to enter into voluntary administration proceeding in Australia.² As provided under the Australian Corporations Act, administrators were appointed to determine whether the Debtor could be restructured or whether it had to be liquidated. The administrators ultimately decided the Debtor should be liquidated, and two of the administrators became the liquidators, responsible for collecting and distributing the company's assets to creditors according to Australian law.³

Entering into voluntary administration breached the Debtor's loan agreements with its secured creditors. Under a procedure that differs substantially from US bankruptcy law, this breach triggered the secured creditors' rights to realize their assets through a separate receivership process prescribed by the Corporations Act.⁴

¹ *In re ABC Learning Centres, Ltd.*, No. 12-2808, ___ F.3d ___, 2013 WL 4516820 (3d Cir. Aug. 27, 2013).

² In Australia, a company's directors may determine the company is insolvent and initiate liquidation proceedings. Australia's Corporations Act. Corporations Act 2001 § 436A (Austl.) (hereinafter, "Corporations Act").

³ Corporations Act §§ 478, 556 (Austl.); Australian Sec. & Invest. Comm'n., *Liquidation: A Guide for Creditors* 2 (2012) available at www.asic.gov.au.

⁴ Corporations Act § 554E (Austl.)

Under Australia's insolvency regime, receivership proceedings function in tandem with liquidation proceedings.⁵ Secured creditors may elect to surrender the secured assets to the liquidator, and receive distribution through the liquidation proceeding, or appoint a receiver to realize the assets.⁶ The receiver represents the interests of secured creditors, whereas the liquidator represents the interests of all the creditors.⁷ The receiver's only duty to unsecured creditors is to sell the assets for a fair price.⁸

Nevertheless, the receiver does not operate entirely independently from the liquidator. The liquidator reviews the appointment of the receiver and monitors the progress of the receivership.⁹ In addition, the liquidator investigates the claims of secured creditors, may challenge asserted claims,¹⁰ and may grant permission to the receiver to operate and manage the company while the liquidator proceeds with winding up the company.¹¹ The receiver must pay to the company any amount realized above the amount of debt owed to the secured creditors.¹²

In the receivership proceeding, the Debtor's secured creditors appointed a receiver to liquidate the secured assets for the benefit of the secured creditors, rather than surrendering the secured assets to the liquidator. The secured creditors were undersecured and held liens on substantially all of the Debtor's assets. Thus, the liquidators agreed to permit the receiver to control and operate the assets of the Debtor.

Bankruptcy Court and District Court Decisions

In May 2010, RCS Capital Development LLC (RCS) won a \$47 million verdict against the Debtor's US affiliate on a breach of contract claim brought in Arizona (the Arizona Verdict). On May 26, 2010, before judgment was entered on the Arizona Verdict, the Australian liquidators petitioned the Delaware Bankruptcy Court for recognition of the liquidation proceeding under Chapter 15 of the Bankruptcy Code.

The Bankruptcy Court determined that the liquidation qualified as a foreign main proceeding by satisfying the requirements set forth in Chapter 15 and did not manifestly contravene US public policy. The Bankruptcy Court determined that the liquidation was (1) a proceeding; (2) either judicial or administrative in character; (3) collective in nature; (4) in a foreign country; (5) authorized or conducted under a law related to insolvency or the adjustment of debts; (6) in which the debtor's assets and affairs are subject to the control or supervision of a foreign court; and (7) which is for the purpose of reorganization or liquidation.¹³ Thus, the Bankruptcy Court concluded that the liquidation proceeding satisfied the definition of "foreign proceeding" contained in section 101(23) of the Bankruptcy Code.¹⁴ The Bankruptcy Court's recognition of the liquidation as a foreign main proceeding resulted in an automatic stay of actions against the Debtor and the Debtor's property within the United States pursuant to Bankruptcy Code §1520.

Although recognition resulted in the stay, the Bankruptcy Court granted RCS's motion to lift the stay for the limited purposes of (i) reducing the Arizona Verdict to judgment; and (ii) authorizing RCS to set off the judgment against claims the Debtor had brought against RCS in Nevada. RCS nonetheless appealed the decision, in an apparent effort to pursue the Debtor's US assets in addition to exercising the rights permitted by the Bankruptcy Court's grant of relief from stay. On appeal, the district court upheld the Bankruptcy Court's orders and noted that RCS was granted all the relief it initially sought. RCS appealed from the district court's order.

⁵ Corporations Act § 420C(1) (Austl.)

⁶ Corporations Act § 554E(3) (Austl.)

⁷ Corporations Act § 420 (Austl.)

⁸ Corporations Act § 420A (Austl.)

⁹ Australian Sec. & Invest. Comm'n., *Receivership: A Guide for Creditors* 4 (2008) available at www.asic.gov.au (hereinafter "Receivership Guide").

¹⁰ Receivership Guide

¹¹ Corporations Act § 420C(1)(a) (Austl.)

¹² Receivership Guide; Corporations Act § 441EA (Austl.)

¹³ *In re ABC Learning Centres, Ltd.*, 445 B.R. 318 (Bankr. D. Del. 2010).

¹⁴ *Id.* at 327.

Third Circuit Decision

On appeal to the Third Circuit, RCS argued that (1) the liquidation proceeding did not satisfy the elements required for recognition; (2) the recognition of the liquidation proceeding was against US public policy; and (3) the Debtor's US assets were not property of the Debtor's estate because the Debtor held no equitable interest in the fully encumbered assets under Australian law as of the commencement of the Chapter 15 case. The Third Circuit affirmed the district court's decision.

i. The Liquidation Proceeding was a "Foreign Proceeding" for purposes of recognition under Chapter 15

RCS argued that the Bankruptcy Court had effectively recognized the receivership, not the liquidation proceeding. Although RCS conceded that the liquidation proceeding was collective in nature, and satisfied all other elements of the definition of "foreign proceeding" contained in the Bankruptcy Code, RCS contended that the receivership was not collective in nature, as the receiver represented only the interests of the secured creditors. Therefore, RCS argued that the receivership should not be recognized as a foreign proceeding.

The Third Circuit dismissed the argument that the parallel receivership proceeding had any effect on the collective nature of the liquidation proceeding.¹⁵ The Third Circuit noted that Chapter 15 mandated recognition once the requisite criteria are met. The court refused to read into the statutory language any exceptions based on the parallel receivership, which the court noted resulted from the circumstances that the debtor's assets are fully secured.¹⁶ The Third Circuit cautioned that providing an exception to recognition in those cases where a debtor's assets were fully secured would contravene the stated purposes of Chapter 15 and the mandatory language of Chapter 15 recognition.¹⁷

ii. Recognition of the Liquidation Proceeding Did Not Violate US Public Policy

RCS also argued that because the receivership proceeding was not collective, and the receivers dominated the liquidation proceeding, recognition of the liquidation proceeding as a foreign main proceeding violated US public policy in favor of collective insolvency proceedings, thus was prohibited by the public policy exception to recognition set forth in section 1506 of the Bankruptcy Code.¹⁸

The Third Circuit rejected RCS's public policy exception argument. The Third Circuit held that the public policy exception is to be narrowly construed and applied only "where the procedural fairness of the foreign proceeding is in doubt or cannot be cured by the adoption of additional protections" or where recognition "would impinge severely a US constitutional or statutory right."¹⁹ The Third Circuit concluded that the system of prioritizing creditors established under Australian law was simply a different method of prioritizing creditors to that provided for under US bankruptcy law but achieved similar goals.²⁰ The Third Circuit's holding is consistent with a number of other recent decisions addressing the public policy exception.²¹

iii. The Debtor's US Assets Formed Part of the Chapter 15 Estate Notwithstanding that the Foreign Receivers Controlled the Assets Under Australian Law

RCS also argued that the Debtor's US assets did not become part of the bankruptcy estate, thus were not subject to the automatic stay upon recognition of the liquidation proceeding as a foreign main proceeding. In

¹⁵ *ABC Learning*, ___ F.3d ___, 2013 WL 4516820, at *5.

¹⁶ *Id.* at *6.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* (quoting *In re Qimonda AG*, 433 B.R. 547, 570 (E.D. Va. 2010)).

²⁰ *Id.*

²¹ See *In re Fairfield Sentry Ltd.*, Case No. 11-4376, 2013 WL 1593348, at *10 (2d Cir. Apr. 16, 2013); *In re Vitro, S.A.B. de C.V.*, 473 B.R. 117 (Bankr. N.D. Tex. 2012) *aff'd* 701 F.3d 1031 (5th Cir. 2012); *In re Ephedra Prods. Liability Litig.*, 349 B.R. 333 (S.D.N.Y. 2006); *In re Toft*, 453 B.R. 186, 189 (Bankr. S.D.N.Y. 2011).

support of its position, RCS asserted that the Debtor's assets in the United States are not "property of the debtor" because the Debtor only holds bare legal title to those assets under Australian law.

The Third Circuit rejected RCS's arguments and concluded that the Debtor retained an equitable interest in its US assets. The Third Circuit conceded that the receiver had the power to operate and manage the Debtor and to use and dispose of the fully encumbered assets. However, the Third Circuit identified several important interests the Debtor retained in the encumbered assets: (1) the right to surplus proceeds from the sale of the assets, (2) the right to redeem the assets under Australian law, and (3) the right to challenge the security interests of the Debtor's secured creditors.

Conclusion

The *ABC Learning* decision is consistent with recent cases establishing that the public policy exception to recognition under Chapter 15 is to be narrowly construed. Specifically, differences in creditor priority schemes between foreign insolvency laws and the Bankruptcy Code are not sufficient to warrant the use of the public policy exception where such foreign laws achieve similar goals to those set forth in the Bankruptcy Code. While the decision is noteworthy because it appears to be the Third Circuit's first substantive ruling in a Chapter 15 case, the decision sheds little light on circumstances that would persuade a court to spurn considerations of comity and international cooperation in invoking the public policy exception.

For a discussion of the Second Circuit's recent decision regarding a Chapter 15 debtor's petition for recognition, click [here](#).

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