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Clarity in comity: Cayman schemes of arrangement capable of discharging New York law debt

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Summary

In *In re Modern Land (China) Co Ltd* (**Modern Land**) the United States Bankruptcy Court recognised proceedings commenced in the Grand Court of the Cayman Islands (**Court**) in respect of a scheme of arrangement.

The ruling in *Modern Land* illustrates the comity shown to foreign insolvency proceedings by the US Bankruptcy Court and confirms that a properly sanctioned scheme of arrangement by the Court is able to compromise and discharge debt obligations that are governed by New York law.

In addition to clarifying that New York law governed debt is capable of being compromised by a foreign insolvency or restructuring process, the judgment went on to consider the legal standards which must be satisfied for foreign insolvency or restructuring proceedings to be recognised as either foreign main or foreign non-main proceedings.

In considering both whether New York law governed debt could be compromised and the form of recognition which the scheme proceedings qualified for under Chapter 15, the US Bankruptcy Court regarded the expectations and views of the creditors of *Modern Land* whose interests were compromised under the scheme as paramount.

Background

The decision of the Hong Kong Court of First Instance (**HKCFI**) *In the Matter of Rare Earth Magnesium Technology Group Holdings Limited* [2022] HKCFI 1686 (**Rare Earth**) recently cast doubt over the ability of a Cayman Islands scheme of arrangement sanctioned pursuant to section 86 of the Companies Act (2022 Revision) (**Act**) to validly discharge debt that is governed by New York law.

On 18 July 2022 Mr Justice Glenn, sitting in the United States Bankruptcy Court of the Southern District of New York, confirmed that a scheme of arrangement sanctioned by a foreign court is in fact capable of modifying or discharging debt governed by New York law.

In his judgment, recognising proceedings commenced in the Cayman Islands relating to a scheme of arrangement as a foreign main proceeding under Chapter 15 of the US Bankruptcy Code, Justice Glenn cited the dicta of Chief Justice Waite that *"the true spirit of international comity requires that schemes of this character,*

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legalised at home, should be recognised in other countries" (**Canada southern Railway Co v Gebhard**, 109 US 527 (1883).

The decision expressly confirmed the ability of Cayman schemes of arrangement to compromise and discharge New York law governed debt obligations, while providing an instructive discussion of the forms of recognition under Chapter 15 that may be available depending on whether the foreign proceedings are pending in a place where the debtor has an establishment or the place of the debtor's centre of main interest (**COMI**).

Facts

Modern Land (China) Co Ltd (**Modern Land**) is a company incorporated under the laws of the Cayman Islands and is the ultimate holding company of a number of companies which carry out real estate investment and development in the People's Republic of China (PRC) and the United States. Since July 2013 the shares issued by *Modern Land* have been listed on the Hong Kong Stock Exchange and its operations were financed in part by bonds issued in the principal amount of US$1.42 billion. The scheme of arrangement presented to Justice Glenn for recognition concerned a restructuring of the outstanding principal of those bonds in the amount of US$1.34 billion (**Existing Notes**). The remaining indebtedness of *Modern Land* in the amount of circa US$3.8 billion was not restructured and was to remain unaffected by the scheme.

The scheme was promoted by *Modern Land* after it failed to meet two repayments due under the Existing Notes, which constituted events of default. With the assistance of legal counsel and retained financial advisors, *Modern Land* commenced discussions with an ad hoc group of holders of the Existing Notes and subsequently entered into a restructuring support agreement (**RSA**). Having obtained the support of creditors holding 80.75% of the total outstanding principal of the Existing Notes, on 14 April 2022 Modern Land filed a petition commencing proceedings to propose and implement a scheme of arrangement under section 86 of the Act implementing the terms of the RSA (**Scheme**).

The terms of the proposed Scheme provided that holders of the Existing Notes would receive a combination of a pro rata share of US$22.916 million cash consideration and new notes issued by *Modern Land*. The Existing Notes would be then be cancelled. As a result, all claims and guarantees under the Existing Notes would be released. On 29 June 2022 the convening meeting of the Scheme took place. 372 creditors voted at the convening meeting, more than 99% of whom voted in support of the Scheme. Only two creditors voted against the Scheme representing less than 1.23% of the total principal amount outstanding under the Existing Notes.

On 5 July 2022 the Court sanctioned the Scheme, with no objections being raised by any creditor at that hearing, and Modern Land being able to implement the Scheme in accordance with its terms. *Modern Land* then filed a motion in the US Bankruptcy Court to have the Scheme recognised as either a foreign main or foreign non-main proceeding pursuant to Chapter 15 of the US Bankruptcy Code (**Recognition Motion**).

Intervening decisions

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Between the Scheme process being initiated in the Cayman Islands and the convening meeting being held, the HKCFI handed down two decisions which potentially impacted on the ability of *Modern Land* to restructure successfully the obligations under the Existing Notes by way of the Scheme. The first was *Rare Earth*, followed by *In the Matter of Global Brands Group Holding Limited (in liquidation)* [2022] KKCFI 1789 (**Global Brands**).

In the *Rare Earth* decision the HKCFI considered the scope of recognition available under Chapter 15 and observed that such recognition was limited to the territory of the US. The HKCFI expressed the view that the territorial imitation of the recognition given under Chapter 15 was because Chapter 15 *"[r]ecognition does not appear as a matter of United States' law to discharge the debt"*. The views of the HKCFI placed a serious question mark over the ability of a foreign proceeding such as a Cayman scheme of arrangement or other restructuring plan to validly compromise debt and obligations governed by the laws of New York, and prompted *Modern Land* to file a briefing with the US Bankruptcy Court on this *"critically important issue"* [9].

In *Global Brands* the HKCFI stated that recognition and enforcement to schemes of arrangement sanctioned by the Courts of the Cayman Islands and BVI would depend on the common law principles developed by the Hong Kong courts that would generally apply a 'centre of main interest' (COMI) test rather than the 'place of incorporation' test. *Modern Land* is incorporated in the Cayman Islands, but operates in the PRC and has its shares listed on the Hong Kong Stock Exchange. In the circumstances, the US Bankruptcy court wished to know whether *Modern Land* would seek recognition in Hong Kong of the Scheme and any recognition order which may be granted by the US Bankruptcy relating to the Scheme.

Issues

As a result of the decisions of the HKCFI out lined above, the efficacy and utility of an order recognising the Scheme under Chapter 15 were called into question, significantly for the *Modern Land* Scheme Justice Glenn was required to consider:

1. whether a foreign scheme or restructuring plan could validly discharge or compromise New York law governed debt;
2. the impact of the *Global Brands* decision on the recognition required for the Scheme to be effective; and
3. whether the Scheme was capable of being recognised as a foreign main or foreign non-main proceeding under Chapter 15.

Decision

Using a foreign scheme or restructuring plan to validly discharge or compromise New York law governed debt

Justice Glenn reviewed the *Rare Earth* decision and whilst expressing great respect for the Hong Kong court found that the HKCFI had misinterpreted earlier decisions of the US Bankruptcy Court which have previously

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recognised and enforced foreign court sanctioned schemes or restructuring plans that modified or discharged New York Law governed debt. Justice Glenn opined that:

"*Provided that the foreign court properly exercises jurisdiction over the foreign debtor in an insolvency proceeding, and the foreign court's procedures comport with broadly accepted due process principles, a decision of the foreign court approving a scheme or plan that modifies or discharges New York law governed debt is enforceable. Under US law, that is an unremarkable proposition that has been firmly establishing in the US at least since the Supreme Court decision*" of *Canadian Railway Co v Gerbhard* (cited above).

Specifically addressing the territorial limits that are placed on Chapter 15 recognition Justice Glenn opined that *"Chapter 15 limits a US bankruptcy court's authority to enjoin conduct outside the territorial jurisdiction of the United States, but it does not make a discharge of New York law governed debt any less controlling"* [9-10]. It was on this basis that Justice Glenn concluded that the discharge of the Existing Notes and issuance of the replacement notes under the Scheme are binding and effective.

Is recognition in Hong Kong required?

In response to the US Bankruptcy court's enquiry, it was confirmed that *Modern Land* would not be seeking recognition or enforcement of the Scheme in Hong Kong. Justice Glenn noted that it was for *Modern Land* to decide in which jurisdictions it was necessary to seek recognition of the Scheme.

On the facts of this case the Existing Notes were issued by a Cayman Islands entity and were governed by New York Law. As a matter of Cayman Islands law the Scheme became effective once a copy of the order sanctioning the Scheme was delivered to the Companies Registrar. As a matter of New York law once the US Bankruptcy Court recognised the Scheme under Chapter 15 the compromise of the Existing Notes under the Scheme would be implemented and effectuated. Furthermore, in the absence of the Scheme requiring any assets of *Modern Land* located in Hong Kong to be obtained, and taking into account that the risk of enforcement action in Hong Kong of the Existing Notes by any holder was *de minimus*, in the circumstances, *Modern Land* did not require the Scheme to be recognised in Hong Kong.

Is a foreign scheme capable of recognition as a foreign main or foreign non-main proceedings under Chapter 15?

The motion for recognition brought in respect of the Scheme sought recognition first as a foreign main proceeding and in the alternative as a foreign non-main proceeding in the alternative. In summary, a foreign proceeding may be recognised as a foreign main proceeding where those foreign proceedings are pending in the jurisdiction of the debtor's COMI. In contrast recognition may be granted as a foreign non-main proceedings where the foreign proceedings are pending in a jurisdiction where the debtor has an *"establishment"* in the sense that the debtor is carrying out a non-transitory economic activity (US Bankruptcy Code, 1502(2)). The assessment of the debtor's COMI or establishment is undertaken by the US Bankruptcy court at the time the application for recognition under Chapter 15 is filed with the court.

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Justice Glenn found that the Scheme did not warrant recognition as a foreign non-main proceeding because on the facts of this case such recognition *"would not comport with the stated goals of non-main proceedings"* and that neither the scheme proceedings in Cayman nor the record-keeping activities of *Modern Land* carried on in the Cayman Islands constituted non-transitory economic activities. Referring to the UNCITRAL Guide to Enactment (2014 (**Guide**) the Bankruptcy court opined that it was not persuaded that the Existing Notes were assets which could give rise to an establishment within the meaning of Chapter 15. This conclusion was premised on a statement in the Guide that *"the existence of debts...would not in principle satisfy the definition of establishment"* (at 25).

Some consideration was given as to whether the process of proposing and implementing the Scheme itself constituted a non-transitory economic activity and might support recognition as a foreign non-main proceedings. On the basis of previous decisions of the US Bankruptcy court which held that the requirements of statutory recognition would be *"pointless" (**In re Pirogova**)* if the mere existence of foreign bankruptcy proceedings could constitute evidence of an establishment, Justice Glenn observed that *Modern Land* maintained a registered office in the Cayman Islands and had initiated the Scheme process in Cayman as its place of incorporation but without more these factors fell *"well short"* of the standards required to demonstrate that *Modern Land* carried on a non-transitory economic activity in the Cayman Islands. Furthermore, in addressing the standard for non-transitory economic activity Justice Glenn found that despite *Modern Land* being a Cayman-incorporated investor which maintains its books and records in the Cayman Islands the fact that its business did not engage the local economy excluded *Modern Land* from having the Scheme recognised as a foreign non-main proceeding.

Justice Glenn went on to find that the Scheme should be recognised as a foreign main proceeding on the basis that the COMI of *Modern Land* was recognised by the US Bankruptcy court as being the Cayman Islands. In doing so His Honour considered the *"totality of the circumstances"* surrounding the Scheme and found that each of the factors discussed below functioned together to support a finding that *Modern Land's* COMI is the Cayman Islands, namely:

1. Goals of Chapter 15

Modern Land argued that if the Scheme process was not recognised as a foreign main proceedings it may have been faced with of the alternative of *"converting a highly consensual Scheme in to a Cayman liquidation in an effort to obtain such chapter 15 recognition as a later date"* (28), with associated costs of an entirely new insolvency process being incurred. Justice Glenn found that such an outcome would *"clearly diverge from Chapter 15's stated goal of maximising the value of the debtors' assets, as well as facilitating the rescue of a financial troubled business"* (28). In addition Justice Glenn expressed the view that granting recognition to the Scheme would further promote cooperation between the US and Cayman courts as contemplated by Chapter 15 with a view to maximising chances of a successful reorganisation.

2. Expectations and intentions of the holders of the Existing Notes as creditors of the Scheme

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Much weight was placed on the *'incontrovertible"* fact that the holders of the Existing Notes understood *Modern Land* is a Cayman Island company and that those holders expected its debts would be restructured pursuant to the law of the Cayman Islands. Referencing the decision on *In re Sphinx, Ltd* Justice Glenn determined that *"when a court considered COMI factors, the protection of creditors interests is paramount"* (30). On the facts of this decision with over 99% in number of holders of the Existing Notes attending and voting at the convening meeting representing approximately 95% in value of the outstanding principal of the Existing Notes, Justice Glenn found the *"definitive creditor expectations and overwhelming creditor support solidify a finding of COMI in the Cayman Islands"* (30).

3. Role of the Grand Court in the Scheme and the insolvency activities in the Cayman Islands

Justice Glenn found that the restructuring process itself supported a finding of *Modern Land* having its COMI in the Cayman Islands, and various aspects of *Modern Land's* dealings with the Cayman Islands were referred to in support of this conclusion. Those aspects included that the historical corporate counsel to *Modern Land* was a Cayman Islands' law firm, and that prior to the Scheme process being commenced a statutory demand was served on the company averring to its being wound up under the laws of the Caymans Islands (32). Turning to the restructuring process itself, *Modern Land* asserted that the vast majority of the activities required for the restructuring took place in the Cayman Islands, including the court hearings necessary to convene a meeting to present the Scheme, and the meeting subsequently convened at which the Scheme was passed.

Significantly, *Modern Land* argued that at the time the Recognition Motion was filed (being the relevant time at which COMI should be assessed for the purposes of Chapter 15) its primary business activity was the restructuring efforts to ensure its survival (3). This argument bought into question whether a finding that *Modern Land* had its COMI in the Cayman Islands would be inconsistent with its status as an exempted company with limited liability. Referring to the decision in *Ocean Rig* (570 B.R.) by the US Bankruptcy court which found that while an exempted limited company could not *trade* from the Cayman Islands they may still be *managed* from the jurisdiction, Justice Glenn found that *Modern Land's "status as an exempted company does not jeopardize its COMI in the Cayman Islands"* (34).

4. Cayman choice of law principles

In the view of Justice Glenn, notwithstanding that the Existing Notes were governed by the laws of New York, *"the Cayman Islands is the jurisdiction whose law would apply to most disputes over corporate actions that may arise in the [Scheme proceedings], this factor supports finding a COMI in the Cayman Islands"*. Justice Glenn went on to note that *Modern Land* also had substantial debt governed by Hong Kong law and found that *"The Court has no reason to address the COMI of any insolvency or scheme proceeding involving creditors with claims other than the holders of the Existing Notes. Creditor expectations in such a case would point to a COMI somewhere other than the Cayman Islands"* (35).

5. Recognition Motion was made in good faith

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A final factor given consideration was the extent to which the Bankruptcy court would deny a recognition of a foreign main proceedings in a debtor's country of incorporation due to the bad faith of the debtor in conducting the relevant restructuring proceedings. On the facts *Modern Land* had not engaged in COMI shifting behaviour and had brought the Recognition Motion in good faith. In doing so, Justice Glenn referred again to the expectations of the holders of the Existing Notes that a restructuring of those notes would likely be carried out under the laws of the Cayman Islands to further support a finding that COMI was in that jurisdiction.

Comment

The decision of Justice Glenn is welcome clarification of the ability of Cayman Islands schemes or arrangements to validly discharge and compromise New York law governed debt obligations. The judgment upholds the principle of comity in cross-border insolvency proceedings in line with the stated objectives of Chapter 15. In addition the ruling reflects the economic realities of financially distressed corporate vehicles that are incorporated in the Cayman Islands, and secure financing in the US markets.

The ruling of *Modern Land* lays to rest the uncertainty which followed The *Rare Earth d*ecision, but the position asserted by the HKCFI in *Global Brands* is a separate and distinct issue that will need to be considered by Cayman debtors who may need to restructure Hong Kong and US law governed debts through separate schemes of arrangement. Taking into account the importance placed by Justice Glenn on creditors' expectations in the assessment of COMI, it is quite possible that a single debtor's COMI may be assessed differently on the recognition of each of those schemes.

Significantly, the distinction drawn by Justice Glenn between the tests applicable to recognition of a foreign non-main proceeding in contrast to a foreign main proceeding under Chapter 15 suggest that recognition as a foreign non-main proceeding is not open to exempted Cayman Islands companies which, by their very nature, are not able to conduct non-transitory economic activities within the jurisdiction. It follows that schemes of arrangement by such entities which look to compromise US law governed obligations may only obtain recognition as a foreign main proceeding.

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