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Short paper

SHOULD A CREDITOR BE BOUND BY THE LEGAL EFFECT OF A FOREIGN INSOLVENCY (AND, IF SO, UNDER WHICH CIRCUMSTANCES)?

Reflections on stay of individual creditor actions in support of foreign insolvency proceedings

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INTRODUCTION

Most insolvency systems around the world contain a rule requiring some sort of moratorium on individual legal actions brought by creditors which (moratorium) takes effect as soon as the debtor is declared insolvent (and, at times, even before a formal insolvency process has been opened). The rationale for the rule is clear: if the debtor is insolvent, there should be orderly distribution of assets as opposed to a 'race to court' among creditors.[1] When all of the debtor's assets are conveniently located within the boundaries of a single jurisdiction, policing compliance with this rule does not pose significant difficulties.

One would expect this rule to work with similar efficacy in cross-border setting, particularly where the debtor has assets in multiple jurisdictions. Yet, the position in cross-border insolvency proceedings is much more nuanced. First, one should not assume that national insolvency rules (including the rules on moratorium) are designed to apply outside of the insolvency jurisdiction. Second, often the only court having effective jurisdiction over a 'hold out' creditor is the (foreign) court hearing that creditor's individual claim. Third, one should not discount the possibility of the debtor starting insolvency in a 'surprise' forum which may sometimes be the jurisdiction having limited connections with the debtor (and, as it happens, some very debtor-friendly rules). The question then arises as to whether foreign courts should respect the choice of forum made by such a 'bankruptcy tourist' and stay actions brought by individual creditors.

Ultimately, the question a creditor faces in these circumstances is whether it would be bound by the moratorium type rules if it were to bring proceedings in jurisdiction other than the insolvency forum. This paper examines the circumstances in which two jurisdictions, Russia and England & Wales, would prevent a creditor from pursuing an individual action and discusses whether a modified approach is needed to take into account the complex circumstances surrounding cross-border insolvencies.

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[1] See, e.g. *McGrath & Ors v Riddell & Ors (Conjoined Appeals)* [2008] UKHL 21 (9 April 2008) at para. 30

CHAPTER I. SETTING THE STAGE

Before addressing the legal issues, one needs to clarify the underlying fact pattern. Consider the following hypothetical: a debtor faces financial difficulties and the court having jurisdiction over the debtor orders opening of formal insolvency proceedings. The relevant jurisdiction will be named "**insolvency jurisdiction**" in this paper, while the court of the relevant jurisdiction will be referred to as the "**insolvency court**".

One of the debtor's creditors finds out that the debtor has assets in a foreign jurisdiction which (assets) are worthy of incurring the legal costs and brings proceedings there. The court seised with such a creditor's claim will be referred to as the "**enforcement court**", the respective jurisdiction is the "**enforcement jurisdiction**", while the relevant claim will be labeled "**individual action**" (as opposed to collective proceedings taking place before the insolvency court).

Now, this is only the general framework. The matter can (and often will) be complicated by a number of variable factors, such as:

a. The insolvency jurisdiction may or may not be the place of debtor's center of main interests. Indeed, in some cases, the debtor's connections to the insolvency jurisdiction will be fairly limited;

b. The creditor may or may not be subject to jurisdiction of the insolvency court (either on the basis of being domiciled in the respective country, because it submitted to jurisdiction voluntarily or for any other reason);

c. The laws of the insolvency jurisdiction may or may not have extraterritorial effect. Indeed, in some jurisdictions the local insolvency law would normally apply within the boundaries of the relevant state, unless the relevant legal provisions are clearly meant to apply outside of the jurisdiction;

d. Finally, the creditor in question may be acting in its own interest (and therefore bringing the proceedings before the enforcement court in order to recover on its own claim) but could also be acting for the benefit of the creditors' as a class (e.g. by undertaking to transfer the assets recovered in the enforcement forum back to the estate).

There are different ways to view this fact pattern. From the perspective of the debtor (and, perhaps, the less active creditors) such a creditor is seeking to circumvent the moratorium imposed under the laws of the insolvency jurisdiction. The trustee in bankruptcy (or other insolvency practitioner appointed by the insolvency court) could argue that the creditor in question usurps his or her powers since only the insolvency practitioner should be collecting the debtor's assets worldwide. Finally, the relevant creditor may be guided by valid considerations, such as the need to freeze the debtor's assets located outside of the reach of the insolvency court in order to avoid asset dissipation by the debtor. This issue would be particularly salient where the insolvency practitioner is, for one reason or another, incapable of bringing proceedings in the enforcement jurisdiction. To capture all of these variables, when referring to the creditor in question, I am going to use the term "**independent creditor**".

Chapter II. Is It Just About Recognition?

An English law-trained practitioner might wonder whether there is an issue at all under the circumstances described in Chapter I. One might say that the position under English law is well-settled thanks to the Cross-Border Insolvency Regulations 2006 ("**CBIR**") which effectively gave the Model Law On Cross-Border Insolvency[2] the force of law in Great Britain.[3]

Indeed, under CBIR, upon recognition of the 'foreign proceeding', the court would normally stay any individual actions brought in English courts. I use the word "normally" because such a stay is automatic in case the insolvency jurisdiction is the country where the debtor has the centre of its main interests[4] and is only discretionary where the debtor only has an 'establishment' within the insolvency jurisdiction.[5]

In other words, one might say that, as far as English law concerned, the matter boils down to whether the foreign insolvency proceedings have been recognized under CBIR or not. Such a point of view, however, would overlook a number of important considerations:

a. CBIR has been interpreted by courts to apply only in relation to foreign insolvency proceedings taking place in the country in which the debtor has his or her centre of main interests or an establishment.[6] If neither is true for the debtor then the foreign representative would have to rely on section 426 of the Insolvency Act 1986 (which only applies with regard to specific countries) and, otherwise, on common law. Recognition at common law is far less streamlined than under CBIR with courts taking into account a wider variety of factors (as discussed below).

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2 Adopted by the United Nations Commission on International Trade Law on 30th May 1997

3 Section 2(1) CBIR

4 Ibid, Article 20(1) of Schedule 1

5 Ibid, Article 21(1)(a) of Schedule 1

6 See, *Kireeva v Bedzhamov* [2022] EWCA Civ 35 (21 January 2022) at 23

b. More importantly, one should not assume that the foreign representative will necessarily be in a position to instruct English counsel and bring proceedings in England. This can be for a number of practical reasons, such as lack of financing from the creditors (or even their opposition to any cross-border action) or, at times, lack of knowledge about the relevant assets or operations of the debtor or even lack of relevant experience.

c. At the same time, nothing prevents the debtor from raising a defence to the individual claim premised on the basis that the creditor is barred by foreign insolvency law from bringing an individual action.[7] Further, it is not unheard of for other creditors to seek to intervene into the individual action in order to prevent their 'competitor' from obtaining recovery outside the ambit of insolvency proceedings.

Accordingly, it would not be entirely correct to say that the issue of staying individual actions boils down to whether the respective foreign insolvency has been recognized, be it under CBIR or on other grounds.

The same is even more true about the Russian legal system. For start, there is not a process for recognition of a foreign insolvency or the powers of a foreign liquidator. The only available procedure for a foreign representative is to apply for recognition of the judgment which gives start to the foreign insolvency proceedings and appoints him or her to the respective position.[8]

But the bigger question is whether the (i) recognition of the foreign insolvency judgment necessarily translates into (ii) stay of individual action. The answer to this is "*not necessarily*".

Some Russian courts have indeed prevented individual actions by independent creditors on the basis that the foreign insolvency judgment has been

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7 See, e.g. *PJSC VTB Bank v Laptev* [2020] EWHC 321 (Ch) (26 February 2020). See, also *WWRT Ltd v Tyshchenko* [2021] EWHC 939 (Ch) (21 April 2021).

8 See, Federal Law dated 26 October 2002 No. 127-FZ On Insolvency (Bankruptcy), Art 1(6)

recognized in Russia.[9] More often, however, Russian courts would rely on the lack of such recognition, in order to decline objections based on foreign insolvency of the debtor.[10] Both of lines of case law would tend to support the notion that the 'stay' largely (if not exclusively) depends on 'recognition'.

At the same time, Russian courts have also been prepared to refer independent creditors to the foreign insolvency proceedings even where no recognition had been obtained. For instance, one court determined that it had to be guided by *lex concursus* and ruled that it was bound by the legal consequences of the foreign insolvency regardless of recognition.[11] In other cases, Russian courts have been prepared to decline jurisdiction simply on the basis that the Russian insolvency legislation prevents individual actions (an approach which has been disfavoured by the Russian appellate courts since Russian insolvency legislation only applies to Russia-seated insolvencies).[12]

All in all, while recognition often translates into stay of individual actions, the lack of recognition does not necessarily mean that the creditor would be allowed to proceed all by itself. The question then is, what are the underlying policy considerations for allowing or disallowing individual actions.

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[9] See, *Mayak CJSC v. Kalinka tade ApS*, Case No. A56-14945/2004, Federal Commercial Court for Northeast Circuit, judgment dated 20 September 2007.

[10] See, *BGP Litigation v. AJZ Engineering GmbH*, Case No. A40-44174/2018; Ninth Commercial Court of Appeal; judgment dated 4 October 2018.

[11] See e.g., Iceberg LLC v Trading Capital LLP, Case No. A09-14352/2014, Bryansk Region Commercial Court, ruling dated 14 January 2016

[12] As an illustration, see Mayak CJSC v. Kalinka tade ApS, Case No. A56-14945/2004, St. Petersburg and Leningrad Region Commercial Court, ruling dated 30 May 2006 (overturned on appeal).

Chapter III. Relevant Factors And How They Are Taken Into Account

It is important to distinguish between (1) factors relevant to recognition of the foreign insolvency and (2) factors relevant to whether or not the individual claim has to be stayed having regard to foreign insolvency. Scholarly works in this area have identified "*a deal of confusion*"[13] between the two issues. As discussed, one does not necessarily equals another.

Broadly speaking, it would seem that courts in both England and Russia look into these two main areas:

a. whether referring the independent creditor into foreign proceedings would be <u>fair to the creditor</u>; and,

   conversely,

b. whether allowing the independent creditor to continue with the individual action would be <u>fair to the creditors as a class</u>.

On the first prong, the courts of the two countries would normally seek to prevent a situation where the creditor's rights would be effectively defeated if it were to barred from pursuing an individual action. In England, one of the notable examples would be *Felixstowe Dock And Railway Co v. US Lines Inc* [1989] 1 QB 360: High Court declined to lift an injunction obtained by one of the creditors of a US company that was subject to US Chapter 11 proceedings . The plaintiff argued that the reorganization plan offered in the US proceedings was such that it would, in effect, gain little to nothing from the plan. The English court sided with the creditor. While the decision was met with some criticism (such that it was not entirely in line with the universality principle), one can appreciate the court's desire to ensure that the independent creditor was not mistreated in the foreign proceedings.

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[13] Sheldon R. QC ed., Cross-Border Insolvency, 4th ed., Chapter 10 Recognition at Common Law, at para. 9.1

The same rationale can be found in some of the Russian judgments addressing the same scenario. By way of illustration, in *Mayak CJSC v. Kalinka tade ApS*[14] the federal appellate court specifically relied on the fact that the creditor was participating, without apparent difficulty, in the Danish insolvency proceedings. The judgment also records the creditor's failure to provide cogent evidence of the risk that it would be treated differently compared to local creditors.

However, what courts seem to be even more concerned is to ensure that the independent creditor does not 'cut corners' by bringing proceedings before the enforcement court, thereby circumventing the overriding principle of (modified) universalism.[15]

To this end, it is noteworthy that many of the underlying cases revolve around considerations of whether the independent creditor is acting in its own interest or in the interests of the creditors as a class. An independent action would normally be opposed with references to the debtor's insolvency and the respective moratorium against 'stand-alone' enforcement. In practice, the latter may argue that the insolvency jurisdiction's rules on moratorium are not meant to be enforced in foreign proceedings (which may or may not be true depending on specific jurisdiction). However, in order to render the argument moot an independent creditor may often be pressed into offering an undertaking to transfer the recoveries from the individual action into the insolvency estate.[16]

While this strategy is a highly effective, it also comes at the (very significant) cost for the independent creditor who would have to assume all the costs and risks of bringing its individual action but then have to share in the profits with those creditors who sat on their hands.

Remarkably, an independent action may still be dismissed on insolvency-related grounds even where the independent action is brought in the interests of all creditors. In *PJSC VTB v Laptev*[17], the creditor (VTB) gave the respective

[14] *Supra* note 9

[15] *Supra* note 1

[16] *Kemsley v Barclays Bank Plc & Ors* [2013] EWHC 1274 (Ch) at para. 16

[17] *Supra* note 7

undertaking to transfer the proceeds of the English litigation into the estate of the debtor who was subject to insolvency proceedings in Russia. Mr Laptev argued that the Russian insolvency-related moratorium was part of Russian contract law and that VTB was prevented by *lex contractus* from bringing its proceedings in England. High Court upheld this line of argument and dismissed VTB's application[18] (a decision which was met with some criticism in the Russian legal community).

Ultimately, what inspired this essay is the question is whether this cautious approach towards individual actions strikes the right balance between the interest of an individual creditor and the interests of the creditors' class as a whole. My thoughts on this will be set out in the conclusion.

[18] *Ibid* at paras. 58 – 66.

Conclusion: Is There A Better Way?

One common thread that follows from the above case law is that individual actions are generally disfavoured by courts, be it in Russia or in England. Somewhat surprisingly, this is so even where a creditor is prepared to give an undertaking that all of the money it collects in foreign proceedings will be transferred into the estate.

The legal basis for such an approach is often found in the concept of universality of insolvency proceedings and, at times, in moratorium rules of either the insolvency jurisdiction[19] or even the enforcement jurisdiction[20]. More generally, however, creditors who are seeking to obtain recourse against the debtor's foreign assets are often viewed as 'hold outs' (to use a more charitable term) who are trying to circumvent the orderly insolvency process.

This approach is intuitively appealing: no one likes when someone else cuts the line.

The problem is that the "line" is not always working properly:

a. First, for the orderly process to work, there has to be a clear framework for an insolvency practitioner from anywhere around the globe to be able to bring proceedings in any other jurisdiction where the debtor's assets may happen to be situated. Despite the groundbreaking developments in the last 25 years, we are not there yet.

b. Second, one should not assume that there is an able and willing foreign trustee in bankruptcy who would be prepared to take action abroad. Or, indeed, even if there is one, there is no guarantee that the creditors as a class would be prepared to fund such an exercise (either from the insolvency estate or otherwise).

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19 *Ibid*

20 See, e.g. *Kireeva v Bedzhamov* [2021] EWHC 2281 (Ch), at para. 97

c. Finally, one should not forget about the problems raised by insolvency tourism where a bona fidae creditor may find itself facing two bad options: either (i) to take part in foreign insolvency proceedings in a jurisdiction which otherwise has little connection with the debtor (and where the debtor is likely to have an advantage) or (ii) bring an individual claim and risk having it dismissed (often, with cost consequences) on the basis of foreign insolvency proceedings.

It seems, under the current system, we would rather let the debtor put its assets overseas (in order to make enforcement against them impracticable for the insolvency practitioner) as opposed to allowing one of the creditors – who is willing to spend its money and time – to get recourse against those assets. The question is whether this approach is right in all circumstances or, rather, whether we need a more nuanced one.

There have been various proposes among scholars. Some would suggest allowing the creditor to retain any assets which fall within its *pro rata* share of the estate while giving the other creditors a claim for any "excess" recovered in foreign proceedings.[21] Others would propose to allow individual actions and only dismiss those claims that are vexatious (even though the scope of "vexatiousness" can be subject to debate).[22]

I would argue that – to the extent an independent creditor is required to return the money collected from individual actions into the estate – it should be rewarded appropriately for the risks it had to take while acting for the benefit of the creditors' as a whole. Rewarding an independent creditor only with its *pro rata* share of distributions from the estate (i.e. in the same way as any other creditor) does not strike the right balance of economic interests. After all, the independent creditor had to finance (what is often) a sophisticated and complex litigation overseas.

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[21] A.V. Egorov. Notes for the seminar titled "*Access to foreign assets of a Russian insolvent debtor and vice versa*", 4 February 2021. Available at: https://civilist.club/event/20210204

[22] E.V. Mokhova. Transnational insolvencies abroad and in Russia: searching for balance between universality and territoriality. Zakon Journal. 2016. No. 5.

To that end, the position of the independent creditor is somewhat akin to a litigation funder. Perhaps, the "reward" to be received should also be proportionate to what a litigation funder would charge for the risks it takes.

Bibliography

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DECLARATION OF HONOUR

I declare that the paper, titled "*Should a creditor be bound by the legal effect of a foreign insolvency (and, if so, under which circumstances)?*"

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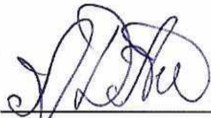
is my own work, that it has been prepared independently and that all references to, or quotations from, the work of others are fully and correctly cited.



Signed

Date: February 9, 2022

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