
# Third-Party Protections in Restructurings

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# Third-Party Protections in Restructurings

*By David A. Murdoch and Josefina Fernandez McEvoy*

This paper was prepared through the collaborative efforts of lawyers in K&L Gates offices across the globe. Mr. Murdoch and Ms. McEvoy are grateful to their colleagues in those offices who helped with the preparation of, or made comments on, this paper: New York (Jeffrey N. Rich and Eric T. Moser); Seattle (Marc L. Barreca); Pittsburgh (David M. Aceto, Kevin J. Dmochowsky, and Jamie L. Burchianti Lopez); London (Edward Smith and Tony Griffiths); Berlin (Rüdiger von Hülst, Eberhardt Kühne, Stefan Kimmel, Oliver Kern and Cornelia Janata) and Hong Kong/Beijing (Clifford Ng and Heather Sun). For additional information about our offices and lawyers please visit www.klgates.com.

## INTRODUCTION

Many countries' bankruptcy and insolvency laws provide financially-troubled entities with the means of reorganizing their financial affairs. Recently, however, developments in some jurisdictions show a trend of extending the relief available under the laws of the applicable jurisdiction to protect third parties who may have or share liability with the reorganizing debtor, such as guarantors, officers and directors of the debtor, or other parties that may share civil liability for injuries caused by the debtor, without necessarily requiring those third parties or their assets to be subject to supervision or administration under such laws. These developments are significant as a matter of domestic bankruptcy policy within each country and as a matter of comparative law. They also present substantial issues of international comity when a third-party non-debtor obtains relief under the laws of one jurisdiction and seeks to enforce or assert that relief in another jurisdiction.

This paper summarizes briefly the availability of such third-party relief under the laws of the United States, the United Kingdom, Germany, and China, and then notes possible issues that may arise with respect to the cross-border recognition of such relief.

## I. THIRD-PARTY PROTECTIONS IN RESTRUCTURINGS UNDER U.S. LAW

With one exception described in section C below, the United States Bankruptcy Code, 11 U.S.C. § 101 *et. seq.* (the "Bankruptcy Code") does not expressly authorize bankruptcy courts to grant permanent injunctive protection from creditor claims against third parties who are not debtors in the case before the court, and the Supreme Court has not ruled on whether bankruptcy courts have the authority to grant such relief. This issue most often arises in the context of orders approving nonconsensual releases[1] and injunctions included in chapter 11 reorganization plans and settlement agreements.[2] Proponents of such protection often rely on § 105(a) of the Bankruptcy Code, which provides that "the court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title," and § 1123(b)(6), which provides that a plan of reorganization may "include any other appropriate provision not inconsistent with the applicable provisions of this title." Opponents of such relief typically rely on § 524(e) of the Bankruptcy Code, which provides that "discharge of the debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." In the absence of a clear rule, the regional United States Courts of Appeals (hereinafter referred to collectively as the "Circuit Courts" or individually as the "First Circuit," "Second Circuit," etc., as applicable) have reached varying and inconsistent conclusions. The following is a brief summary of the principal decisions at the Circuit Court level regarding the authority of a bankruptcy court to grant permanent protection to non-debtor third parties, typically in the form of releases or injunctions against enforcement of claims against the third parties.[3]

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[1] The use of the term "release" in this context can be somewhat misleading since, under U.S. law, the word "release" connotes a voluntary contractual act by the releasing creditor rather than a court-ordered extinguishment of a claim.

[2] It is beyond the scope of this memorandum to address the effect of exculpation provisions in chapter 11 plans for accounting and legal professionals, creditor committee members, future claims representatives and others who engage in the formulation or administration of such plans.

[3] *Limiting Third Party's Liability to Nonconsensual Creditor*, THOMPSON WEST BANKRUPTCY NEWSLETTER, April 2, 2008, http://west.thompson.com/bankruptcy/newsletter/2008-04-02.aspx; American Bankruptcy Institute, *Chapter 11 Working Group Proposal #6: Release of Claims Against Non-Debtor Parties*, 2008, http://www.abiworld.org/AM/Template.cfm?Section=Working_Group_Proposals&Template=/CM/ContentDisplay.cfm&ContentID=36458; *Dow Corning and Tort Committee Ask District Judge to Vacate Bankruptcy Judge's Opinion on Third Party Release to Allow Joint Plan to Go*

### A. Bankruptcy courts may generally grant releases or injunctions in favor of third-party non-debtors if unusual circumstances exist.

#### 1. *"Consensual" Releases.*

Two Circuit Courts have held that a court may approve a plan of reorganization that provides that creditors who support the plan or accept benefits under the plan are considered to have released claims against non-debtor third parties. *See, e.g.*, *Specialty Equip. Co., Inc. v. Gen. Elec. Capital Corp.*, *(In re Specialty Equip. Co., Inc.)*, 3 F.3d 1043 (7th Cir. 1993). *Specialty Equip.* involved a plan that provided for release of third-party non-debtors by the creditors voting to accept the plan. *Id.* The Seventh Circuit held that "a per se rule disfavoring all releases in a reorganization plan would be…unwarranted…Accordingly, courts have found releases that are consensual and non-coercive to be in accord with the strictures of the Bankruptcy Code." *Id*. at 1047.

In *In re AOV Indus.*, 792 F.2d 1140 (D.C. Cir. 1986), the bankruptcy court confirmed a plan providing a 4% recovery for all creditors based on the available assets of the debtor, with the opportunity of recovering an additional 13% distribution from funds provided by two third parties (a shareholder and the debtor's marketing agent) who had been alleged to be liable to the debtor based on their dealings with the debtor, in exchange for a release of claims against those third parties by each creditor making the election. The appeals court did not appear

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*Forward*, PRNEWSWIRE, Jan. 6, 2000, http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/01-06-2000/0001109510&EDATE=.; Wendell H. Adair, Jr. and Kristopher M. Hansen, *The Discharge of Non-Debtor Parties in Bankruptcy*, THE JOURNAL FOR CORPORATE RENEWAL, May 1, 2000, *available at* http://www.turnaround.org/Publications/Articles.aspx?objectID=1324; Chapter 11: Third Party Releases, January 12, 1998, http://www.abiworld.org/AM/PrinterTemplate.cfm?Section=Submission_Abstract&Template=/CM/ContentDisplay.cfm&ContentID=36621.

to object to the concept of a voluntary release, but it concluded that the plan was unfair to a creditor who had a separate claim against one of the third parties based on a disputed guarantee by that third party, because the plan required that creditor to give up more value in the exchange than the other creditors were required to provide. *Id*. at 197-200.

### 2. *Protection available under special circumstances.*

Various Circuit Courts have held or suggested that it is appropriate to enter an order approving a plan of reorganization or settlement that may protect non-debtor third parties against claims by creditors under special circumstances or under the specific facts of the case. However, no consistent standard has been adopted.

*SEC v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 960 F.2d 285 (2d Cir. 1992) concerned a settlement agreement containing a provision enjoining members of a subclass from bringing future actions against the debtor's directors and officers. The Second Circuit held that the settlement agreement was properly approved by the lower court because the settlement agreement was an essential element of the debtor's ultimate reorganization and the injunction was a key part of the settlement agreement. *Id*. at 292-93. "[A] court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan" or when the estate receives substantial consideration. *Id*. at 293. In a more recent case, the Second Circuit held that a non-debtor release should only be granted in unusual circumstances and when the release is important to the plan, since (a) there is no explicit authorization in the Bankruptcy Code for non-debtor releases except for those in asbestos cases under certain circumstances, (b) § 105(a) of the Bankruptcy Code does not allow the bankruptcy court to "create substantive rights that are otherwise unavailable under applicable law," and (c) the grant of such releases lends itself to abuse. *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 141-42 (2d Cir. 2005). The potential for abuse is increased when the release grants blanket immunity to the third-party non-debtor. *Id*. quoting *New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores, Inc.)*, 351 F.3d 86, 92 (2d Cir. 2003).

Like the *Drexel Burnham* case, *Menard-Sanford v. Mabey (In re A.H. Robins Co., Inc.)*, 880 F.2d 694 (4th Cir. 1989) dealt with an injunction for the benefit of third-party non-debtors in the context of a very large pool of potential claimants. In *Robins*, a reorganization plan contained a provision enjoining mass tort claimants from suing all third parties other than insurers and from asserting claims based exclusively on medical malpractice, but the enjoined claimants were given the opportunity to receive payment for their claims in full under a related settlement agreement. *Id*. at 701. The Fourth Circuit held that under the circumstances of the case, § 524(e) of the Bankruptcy Code did not operate as a prohibition on the power of the bankruptcy court to enjoin suits. The Fourth Circuit also held that the plan was properly confirmed because the injunction was integral to the reorganization of the debtor. In that case, the debts of third parties were not discharged because provision had been made in full for all enjoined claimants. *Id*. at 702.

In 2002, the Court of Appeals for the Sixth Circuit set forth one of the clearest standards for when third-party relief should be granted. *Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648 (6th Cir. 2002) addressed a chapter 11 plan containing releases and injunctions protecting the debtor’s insurers and shareholders from liability arising out of personal injury claims relating to a product manufactured and sold by the debtor. The Sixth Circuit held that nonconsensual releases and injunctions against non-debtor creditors in chapter 11 plans of reorganization may be confirmed under certain "unusual circumstances," but held further that the record before it did not establish such circumstances. *Id*. at 658. The court interpreted the "unusual circumstances" standard to mean that a bankruptcy court may enjoin nonconsenting creditors, when the following seven factors are present:

> (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;
>
> (2) the non-debtor has contributed substantial assets to the reorganization;
>
> (3) the injunction is essential to reorganization, namely the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;
>
> (4) the impacted class, or classes, has overwhelmingly voted to accept the plan;
>
> (5) the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction;
>
> (6) the plan provides an opportunity for those claimants who choose not to settle to recover in full; and
>
> (7) the bankruptcy court made a record of specific factual findings that support its conclusions.

*Id*. at 658. (In subsequent proceedings applying that standard, the lower court found that special circumstances existed and confirmed a plan containing the protection for shareholders and insurers.).

Like *Dow Corning*, the Seventh Circuit Court of Appeals in *Airadigm Commc'ns, Inc. v. FCC (In re Airadigm Commc'ns, Inc.)*, Nos. 07-2212, 07-2430 & 07-2529 (7th Cir. March 12, 2008) recently set forth a specific standard for when a third-party release or injunction may be granted, but it did not adopt the seven-prong standard outlined in *Dow Corning*. There was a reorganization plan in *Airadigm* releasing a third party from all liability "in connection with" the reorganization, except for willful misconduct. *Id*. In *Airadigm*, the Seventh Circuit held that the release was appropriate because the release was limited, was subject to other provisions of the plan, and was required by the third party before the third party would agree to provide financing that was essential to the reorganization. *Id*. The court held that § 524(e) of the Bankruptcy Code does not limit the court's powers to release a non-debtor from a creditor's claims. *Id*. The court went on to hold that § 105(a) and § 1123(b)(6) of the Bankruptcy Code permit the bankruptcy court to release third parties if the release is "appropriate" and not inconsistent with any provision of the Bankruptcy Code. *Id*. Whether a release is "appropriate" is a fact-specific question and the court will take into consideration different factors. *Id*. An important factor the Seventh Circuit considered in determining "appropriateness" was whether the release was essential to the debtor's reorganization. *Id*. The court mentioned in *dicta* that a grant of blanket immunity may be too broad so that it is not "appropriate" to grant the release. *Id*.

In contrast to the Second, Sixth and Seventh Circuits that articulated standards for disposition of this issue, the Courts of Appeals for the Third Circuit and the Fifth Circuit did not adopt a formal standard relating to third-party releases and injunctions, but they did not preclude such relief. In *Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203 (3d Cir. 2000), a reorganization plan included provisions releasing and permanently enjoining shareholder lawsuits against a Chapter 11 debtor airline's non-debtor officers and directors. The Third Circuit did not establish a firm rule as to when such releases would be acceptable, but held that under the facts of the case, the plan could not be confirmed because the release and injunction were "legally and factually insupportable" under even the "most flexible tests for the validity of non-debtor releases," because fairness, necessity to the reorganization and specific factual findings to support the conclusions were all absent. *Id*. at 214.

In *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746 (5th Cir. 1995), a debtor settled its claims against three former directors and the issuer of its primary directors and officers' ("D&O") insurance policy. To implement the settlement, the bankruptcy court enjoined two parties who were not part of the settlement -- a fourth director and the issuer of excess D&O coverage -- from asserting claims against the settling directors or the primary insurer. *Id*. at 750. Relying in part on § 524(e) of the Bankruptcy Code and upon the limited nature of a bankruptcy court's jurisdiction, the court of appeals reversed the bankruptcy court. *Id*. at 757. The Fifth Circuit appears to have left open the possibility of an injunction such as that in *Drexel* that provided an alternative source of fair recovery for contract-based claims.

*Munford v. Munford, Inc. (In re Munford, Inc.)*, 97 F.3d 449 (11th Cir. 1996) also concerned a settlement agreement. The settlement was between a debtor and a defendant and enjoined nonsettling defendants from pursuing contribution or indemnification claims against the settling defendant. *Id*. at 452. The Eleventh Circuit held that the permanent injunction was integral to the debtor's settlement and that the order was fair and equitable. *Id*. at 455-56. The court relied on § 105(a) of the Bankruptcy Code and Federal Rule of Civil Procedure 16, which when read together give bankruptcy courts the power to use special procedures to assist in resolving a dispute with respect to settlement. That power includes the ability or capacity to enjoin a nonsettling defendant. *Id*.

### B. Courts that have held that releases of third parties are prohibited.

The Ninth and Tenth Circuits have held that § 524(e) of the Bankruptcy Code explicitly prohibits the nonconsensual release of non-debtor third parties. *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss),* 67 F.3d 1394 (9th Cir. 1995); *Landsing Diversified Properties-II v. First Nat'l Bank & Trust Co. of Tulsa (In re Western Real Estate Fund, Inc. et al.)*, 922 F.2d 592 (10th Cir. 1990).

In *Lowenschuss*, a chapter 11 reorganization plan that contained a broad discharge of all claims against a non-debtor was confirmed by the bankruptcy court. 67 F.3d 1394. The Ninth Circuit held that the plan should not have been confirmed by the bankruptcy court because § 524(e) of the Bankruptcy Code "precludes bankruptcy courts from discharging the liabilities of non-debtors." *Id*. at 1401. The Ninth Circuit rejected the argument that the general equitable powers of the bankruptcy court pursuant to § 105(a) of the Bankruptcy Code permit the bankruptcy court to discharge the liabilities of non-debtors because "the specific provisions of § 524 displace the court's equitable powers under § 105." *Id*. at 1402 *quoting Am. Hardwoods, Inc. v. Deutsche Credit Corp. (In re Am. Hardwoods, Inc.),* 885 F.2d 621, 625-26 (9th Cir. 1989).

The Tenth Circuit also held that Congress did not intend for § 524(e) of the Bankruptcy Code to release third parties permanently from liabilities. *Landsing*, 922 F.2d 592. The court held that to do so would be inconsistent with § 105(a) since a bankruptcy court's equitable powers cannot be exercised in a manner that is inconsistent with more specific provisions of the code. *Id*. at 601.

### C. In cases involving asbestos-related liabilities, bankruptcy courts may generally release or enjoin third-party non-debtors under § 524(g) if statutory conditions are met.

Section 524(g) of the Bankruptcy Code provides explicit authorization for granting broad-ranging injunctive relief necessary to facilitate a comprehensive resolution of a debtor's asbestos-related liabilities.[4] H. Rep. 103-835, 2d Sess., 40-41 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3348-49. Section 524(g) authorizes the issuance of a "channeling injunction" in connection with an order confirming a plan of reorganization. The channeling injunction precludes holders of "claims" or "demands" from seeking payment from the debtor or specified categories of third parties with respect to those claims and demands, if the plan provides for those claims or demands to be paid out of a settlement trust fund meeting specified conditions and if holders of future demands were represented in the reorganization case. 11 U.S.C. § 524(g).

Section 524(g) was enacted in 1994, in part, to provide certainty to the financial community regarding the validity of the trust and channeling injunction structure used in the *Johns-Manville* and *UNR* bankruptcy cases, thereby making it easier for companies emerging from asbestos-related bankruptcies to raise capital and generate profits that could be used to satisfy future claims and demands. 140 Cong. Rec. H10, 765 (daily ed. 1994) ("Asbestos claimants would have a stake in [a] successful reorganization, because the company's success would increase both the value of the stock held by the trust and the company profits set aside for it.") (alteration in original).

[4] Section 524(g) of the Bankruptcy Code is attached hereto as Exhibit A.

### 1. *Scope of Channeling Injunctions.*

Section 524(g) of the Bankruptcy Code is an important source of relief for debtors and their non-debtor affiliates facing present and future claims arising out of the alleged presence of or exposure to asbestos.[5] Section 524(g) explicitly authorizes the extension of injunctive relief to non-debtor entities for:

> any action directed against a third party who … is alleged to be directly or indirectly liable for the conduct of, claims against, or demands on the debtor to the extent such alleged liability of such third party arises by reason of—
>
> (I) the third party's ownership of a financial interest in the debtor, a past or present affiliate of the debtor, or a predecessor in interest of the debtor;
>
> (II) the third party's involvement in the management of the debtor or a predecessor in interest of the debtor, or service as an officer, director or employee of the debtor or a related party;
>
> (III) the third party's provision of insurance to the debtor or a related party; or
>
> (IV) the third party's involvement in a transaction changing the corporate structure, or in a loan or other financial transaction affecting the financial condition, of the debtor or a related party, including but not limited to—
>
> (aa) involvement in providing financing (debt or equity), or advice to an entity involved in such transaction; or
>
> (bb) acquiring or selling a financial interest in an entity as part of such transaction.

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[5] One court has construed § 524(g) to authorize the issuance of a channeling injunction to include both asbestos-related liabilities and non-asbestos-related liabilities. See In re Eagle-Picher Indus. Inc., 203 B.R. 256, 267 (S.D. Ohio 1996) (issuing channeling injunction regarding both asbestos and lead-related liabilities, noting that while § 524(g) was enacted principally to respond to asbestos-related liabilities, "the language of the statute itself contains no requirement that claims of another sort must be excluded from the trust.").

11 U.S.C. § 524(g)(4)(A)(ii).

While the categories contained in § 524(g)(4)(A)(ii) are broad, they are not without limits.[6]

### 2. *Conditions for Issuing a Channeling Injunction under § 524(g).*

Debtors and non-debtor entities within the categories enumerated in § 524(g)(4)(A)(ii) must satisfy a number of additional conditions before the court will issue an injunction that channels their asbestos liabilities to the settlement trust.

First, the settlement trust itself must satisfy several conditions. 11 U.S.C. § 524(g)(2)(B). Under § 524(g), the trust must: (I) assume the liabilities of a debtor which is a defendant in bodily injury, wrongful death, or property damage actions for damages allegedly caused by asbestos; (II) be funded, at least in part, by securities of one or more debtors and an obligation by the debtor(s) to make future payments; (III) own or have the right to acquire a majority of the voting shares of (aa) each debtor; or (bb) the parent corporation of each debtor; or (cc) a subsidiary of each debtor that is also a debtor; and (IV) use its assets or income to pay claims and demands. 11 U.S.C. § 524(g)(2)(B).

Second, the court must determine that the debtor is likely to be subject to substantial future demands for payment arising out of conduct that gave rise to asbestos liability claims; that the actual amounts, number, and timing of the future demands are indeterminate; and that the pursuit of such demands outside the procedures prescribed by the plan is likely to

[6] In one case where the parties did not contend that the non-debtor parties were "liable for the conduct of, claims against, or demands on" the debtor, the court observed that § 524(g)(4)(A) did not authorize extending the channeling injunction to those non-debtors. *See In re Combustion Engineering, Inc.*, 391 F.3d 190, 235 (3d Cir. 2004).

threaten the plan's purpose to deal equitably with claims and future demands. 11 U.S.C. § 524(g)(2)(B)(ii)(I-III).

Other conditions that must be satisfied before a channeling injunction will be issued are specifically tailored to protect the interests of future claimants. Such conditions include a finding by the court that the trust will operate in such a manner as to provide "reasonable assurance that the trust will value, and be in a financial position to pay, present claims and future demands that involve similar claims in substantially the same manner." 11 U.S.C. § 524(g)(2)(B)(ii)(V). The trust need not be able to pay the claims *in full*, so long as it will pay similar claims *equally*. Furthermore, holders of present claims must approve the plan by a vote of at least 75% in number of those voting, rather than the mere majority vote ordinarily required for a plan. 11 U.S.C. § 524(g)(2)(B)(ii)(IV)(bb). Moreover, in order for the injunction to bind future claimants (holders of "demands"), a legal representative must be appointed to protect their rights. 11 U.S.C. § 524(g)(4)(B)(i).

Finally, the court must find that granting protection to the debtor or the third party in the injunction with respect to future demands is "fair and equitable" with respect to future claimants "in light of the benefits provided, or to be provided to such trust on behalf of such debtor or debtors or such third party." 11 U.S.C. § 524(g)(4)(B)(ii). That requirement makes explicit what was already inherent in the rationale for § 105 relief awarded to third parties: namely, that protection in theory is offered only in exchange for benefits made available to the trust by or on behalf of the third party. The court's evaluation of the fairness of a release to a third party and the benefits provided to future claimants by such party may be informed, among other things, by its assessment of the merits of potential claims against such party as well as any funding provided by or on behalf of such party from insurance or otherwise.

If both the trust and the third-party debtor/non-debtor satisfy the requirements of § 524(g), the bankruptcy court may issue a channeling injunction that requires the holders of asbestos-related claims or demands to seek payment solely from the settlement trust. 11 U.S.C. § 524(g)(1)(B). Once entered, the channeling injunction "may not be revoked or modified by any court except through appeal." 11 U.S.C. § 524(g)(3)(a)(i). Under this provision, the court manages all present and future claims, thereby allowing the entities covered by the terms of the injunction to resolve their present and future asbestos-related liabilities.

## II. THIRD-PARTY PROTECTIONS IN RESTRUCTURINGS IN THE UNITED KINGDOM, GERMANY, AND CHINA

The foregoing discussion of U.S. law relating to third-party protections in restructurings necessarily raises in an international context two major questions:

(1) What is the substantive law in non-U.S. jurisdictions relating to possible protection of third parties, and specifically directors and officers, in the restructuring of an insolvent company?

(2) Will a non-U.S. jurisdiction recognize the protection of third parties obtained in a U.S. restructuring?

These two questions have numerous subparts and issues beyond the scope of this memorandum, but a brief overview of these subjects, as the law is now developing in the United Kingdom, Germany, and China, highlights the challenges ahead for the international insolvency professional community and for those concerned with cross-border insolvency issues.

### A. The United Kingdom.

The UN Commission on International Trade Law ("UNCITRAL") Model Law on Cross Border Insolvency (the "Model Law") was implemented in England, Wales and Scotland on April 4, 2006 by the Cross-Border Insolvency Regulations 2006 (SI 2006/1030) (the

"Regulations").[7] This voluntary framework does not attempt to impose a global insolvency law or to harmonize local laws but assists with the coordination and administration of cross-border insolvencies of non-EU companies. The U.S. adopted the Model Law in 2005, under the new Chapter 15 of the Bankruptcy Code.

Central to the Regulations is the rule that a foreign officeholder can apply to the British courts for recognition of foreign proceedings where the debtor has a place of business or assets in Great Britain or if, for any other reason, Great Britain is an appropriate forum (Articles 4 and 15).

Foreign proceedings for which recognition may be sought are collective insolvency proceedings, which are subject to the supervision and control of a foreign court. This excludes receiverships or equivalent foreign proceedings but would include a court order approving a plan of reorganization under U.S. chapter 11 reorganizations ("Chapter 11 Plan").

There is no direct equivalent to a Chapter 11 Plan in the law of the United Kingdom. The closest comparisons are found in so-called CVAs, i.e., Company Voluntary Arrangements under Part 1 of the Insolvency Act of 1986, and schemes of arrangement under § 895 of the Companies Act 2006 ("Schemes"). In theory, third parties (such as directors and officers) could be released from liability under these provisions.

CVAs and Schemes are contractual agreements that enable distressed companies to propose a compromise of some or all of their liabilities with a view to continuing their business. A CVA, if approved by 75% of voting creditors by value, becomes binding on all

[7] Comparable legislation was enacted in Northern Ireland on April 12, 2007.

creditors, even those who vote against the proposed compromise. A Scheme requires separate classes of creditors to meet and vote in favor of the proposed compromise. Only if the Scheme is approved by 75% of voting creditors in each meeting will it be effective.

A recent case in the United Kingdom held that a CVA should not be used to deprive creditors of valuable guarantee rights they may have against solvent third parties. *Prudential Assurance Co Ltd & others v. PRG Powerhouse Limited & others* ([2007] EWHC 1002 Ch). A K&L Gates Alert from London is attached to this memorandum as Exhibit B. Thus, legally-bound guarantors cannot avoid their obligations through a CVA. It appears, as a result of the *Powerhouse* case, that where guarantees exist between a creditor and a third-party guarantor, contractual agreements between the principal and the creditor cannot be used in a CVA to set aside such guarantees. The judge found that such a result would be illogical and unfair. However, a Scheme would permit the contemplated releases, albeit that the affected creditors would need to vote, in their own meeting, in favor of the Scheme. In other words, in English law, affected creditors cannot be "crammed down" without the protection of a Scheme, if the result would produce an unfair consequence.

With respect to recognition of an order or judgment confirming a Chapter 11 Plan that provides protections, such as releases or injunctions, for certain third parties (like directors and officers), the U.K. courts will look to the Model Law and the Regulations to determine whether it is appropriate to grant relief in the U.K. to such third parties. At the time of this writing, no definitive U.K. case that addresses this specific issue has been decided. However, so long as a Chapter 11 Plan that releases third parties has been properly approved by the U.S. creditors and further approved by a court under U.S. law, a U.K. court should recognize the rights of a U.S. "foreign representative" (e.g., a trustee) to enforce the terms of the Chapter 11 Plan, including the release.

**B. Germany.**

The German Insolvency Code (*Insolvenzordnung – InsO*) does not provide specific provisions for the release of directors and officers in a general insolvency proceeding (*Insolvenzverfahren*) or an insolvency plan procedure (*Insolvenzplanverfahren*), but a release from certain obligations or liabilities can be granted under certain conditions.[8] Attached to this Memorandum as Exhibit C is a memorandum from the Berlin office of K&L Gates entitled "Liability and Release of Such Liability of Directors under a Plan of Reorganization" (the "Berlin Memorandum"). The Berlin Memorandum addresses three questions: (1) the liability of directors in insolvency proceedings under German law (both Civil and Criminal Liability); (2) the release of directors in connection with a plan of reorganization under German law; and (3) recognition of a confirmed plan of reorganization under U.S. law by German Courts.

The reader should refer to the Berlin Memorandum for more specific detail, but a short summary of that discussion is appropriate. Directors of German limited liability companies (*Gesellschaft mit beschränkter Haftung – GmbH*) face potential civil and criminal liabilities in connection with insolvency proceedings. The management board (*Vorstand*) of a corporation (*Aktiengesellschaft*) may incur liability under similar but not identical rules.

With respect to civil liability, directors of a GmbH may be liable to the company if they violate their duties under § 43 paragraph 2 of the German Limited Liability Company Act

[8] This section, as well as the section below on China, speaks specifically to director and officer releases rather than to releases generally.

(the "GmbHG") or § 64 paragraph 2 of the GmbHG. Any claims arising out of internal liability vis-à-vis the company can be asserted by the insolvency administrator.

External liability for directors may arise under § 823 paragraph 2 of the German Civil Code ("BGB") in connection with § 64 of the GmbHG. Under these provisions, directors are liable for damages to the creditors if they neglect to file for insolvency in the event of "over-indebtedness" or illiquidity without undue delay, and, in any event, at least within three weeks. In order to be held liable, directors must have at least acted negligently.

The German Insolvency Law does not explicitly provide for a release of directors and officers in connection with a plan of reorganization. It also does not provide for injunctions or stays under a confirmed plan of reorganization, as contemplated by Chapter 11 Plans in the U.S. The very limited circumstances under which a release of liability might be available or attainable for directors and officers of a German plan of reorganization are discussed in the attached Berlin Memorandum.

The German Insolvency Law contains certain provisions (§ 335 et. Seq. InsO) with regard to the recognition of foreign insolvency proceedings under German Law. In general, under these provisions, international insolvency proceedings are governed by the national law of the country where the insolvency proceedings are instituted. Hence, insolvency proceedings and their legal effects under U.S. law would be generally recognized under German Law.

Notwithstanding this general principle of recognition, no controlling German law has been identified that would assure that the release of a director or officer from liability under U.S. law in a confirmed Chapter 11 Plan would be honored by a German court. Of particular concern would be the policies of international comity, the invocation of the German Insolvency

Law provisions relating to recognition of foreign insolvency proceedings, and the possible conflict in public policy between a Chapter 11 Plan provision that released a director or officer from liability and the German laws imposing liability on officers and directors in an insolvency context.

**C. China.**

The new Enterprise Bankruptcy Law of PRC (the "New Bankruptcy Law") was adopted on August 27, 2006 and became effective June 1, 2007; it supersedes the 1986 enacted Enterprise Bankruptcy Law (Trial) in China. The Hong Kong Office of K&L Gates has provided a brief introduction to China's New Bankruptcy Law in a memorandum attached hereto as Exhibit D.

The New Bankruptcy Law in China provides specifically in articles 6 and 129 that a director/executive of an insolvent enterprise is subject to civil liabilities for breaches of the duty of loyalty or diligence. The New Bankruptcy Law prohibits such personnel from becoming a director, supervisor or executive of any other enterprise within three years following the completion of the bankruptcy.

The New Bankruptcy Law does not address whether a director can obtain a release from obligations under a reorganization plan. Since China has a civil law system, there is no nationwide and unified case law system available to the general public to ascertain precedents on this issue.

The New Bankruptcy Law, however, provides that creditors' rights against third parties, who are guarantors of the insolvent enterprise or are co-debtors with joint and several liabilities with the insolvent enterprise, shall not be affected by a compromise agreement that restructures the enterprise.

With respect to possible recognition of an order approving a U.S. Chapter 11 Plan that provided certain protections for third parties, such as releases or injunctions, a China court may recognize and enforce legally valid foreign bankruptcy court judgments and rulings involving an insolvent enterprise's property and assets located within China. However, a China court will require that a treaty or principle of reciprocity in bankruptcy proceedings (or judgments in them) exist and that the bankruptcy proceeding or petition does not contravene basic principles of Chinese law, prejudice the sovereignty, security, and public and social interest of China, or hurt the legitimate rights and interest of creditors in China.[9]

## III. RECOGNITION OF THIRD-PARTY PROTECTIONS IN CROSS-BORDER RESTRUCTURINGS UNDER THE MODEL LAW AND INTERNATIONAL COMITY

Once a court grants relief from creditor claims to a third-party non-debtor, the remaining question is whether such protections will be recognized and enforced by the courts of other countries. For example, will a U.S. court recognize and enforce the judgment of a non-U.S. Court releasing or enjoining a third-party non-debtor from claims by creditors? Conversely, would a non-U.S. court enforce a U.S. order approving a Plan of Reorganization releasing a third-party non-debtor from any claims by creditors?

[9] Chapter 15 of the Bankruptcy Code incorporates the Model Law. If U.S. courts grant recognition to decisions of China courts with respect to insolvency proceedings, then arguably Chinese courts should grant recognition to U.S. court rulings based on principles of reciprocity.

Historically, countries have recognized and enforced foreign judgments based on principles of international comity and cooperation.[10] While the principles of comity provide some guidance as to how courts will address cross-border insolvency issues, problems of predictability and reliability concerning such approach illustrate the need for establishing a well-developed international legal framework addressing the recognition and enforcement of third-party protections granted by courts in other countries. To date, virtually no countries have the legislative framework for dealing with third-party protections that is suitable for the needs of the international business community. Moreover, no international treaties were located that identify the parameters of when courts will recognize and enforce foreign third-party protections in insolvency proceedings. For example, Article 1 of Hague Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters, Feb 1, 1971, 1144 U.N.T.S. 257, specifically excludes "decisions the main object of which is to determine … (5) questions of bankruptcy, compositions or analogous proceedings, including decisions which may result therefrom and which related to the validity of the acts of the debtor."

In an attempt to establish a flexible international legal framework that addresses such issues, UNCITRAL promulgated the Model Law. However, the Model Law does not provide specific guidance as to the enforceability of a foreign order or judgment; and very few countries have adopted the Model Law.[11]

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[10] See Hilton v. Guyot, 159 U.S. 113, 136 (1895); TRANSNATIONAL INSOLVENCY: COOPERATION AMONG THE NAFTA COUNTRIES, PRINCIPLES OF COOPERATION AMONG THE NAFTA COUNTRIES (Am. Law Inst. 2003).

[11] According to the UNCITRAL Web Site, the following countries have adopted legislation based on the Model Law: Australia (2008), British Virgin Islands, an overseas territory of the United Kingdom of Great Britain, and Northern Ireland (2005), Colombia (2006), Eritrea, Great Britain (2006), Japan (2000), Mexico (2000), Montenegro (2002), New Zealand (2006), Poland

In the U. S., chapter 15 of the Bankruptcy Code incorporates the Model Law. Upon recognition of a foreign proceeding, U.S. courts are granted broad discretion under chapter 15 to grant "any appropriate relief" to protect the assets of the debtor or the interests of the creditors.[12] See 15 U.S.C. § 1521.

The recognition and enforcement of third-party protections in restructurings granted by courts in other countries is a complex issue requiring further attention.[13]

**CLOSING**

The potential scope of third-party protection in conjunction with a bankruptcy or insolvency proceeding is an evolving, but unsettled, area of the law. Given the continued expansion of enterprises with international operations and, hence, international creditors, the potential for providing protection to third-parties in connection with bankruptcy or insolvency proceedings is likely to be an important issue for years to come, pending the development of a more predictable set of principles governing cross-border recognition of such relief.

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(2003), Republic of Korea (2006), Romania (2003), Serbia (2004), South Africa (2000), and the United States of America (2005).

[12] For an excellent discussion of certain discharge issues under Chapter 15, *see* Jay Lawrence Westbrook, *Beneath the Surface of the BAPCPA: Chapter 15 and Discharge*, 13 AM. BANKR. INST. L. REV. 503 (Winter 2005).

[13] A more detailed analysis of this issue is outside the scope of this paper.

**Exhibit A**
**Section 524(g) of the Bankruptcy Code**

(g)(1)(A) After notice and hearing, a court that enters an order confirming a plan of reorganization under chapter 11 may issue, in connection with such order, an injunction in accordance with this subsection to supplement the injunctive effect of a discharge under this section.

(B) An injunction may be issued under subparagraph (A) to enjoin entities from taking legal action for the purpose of directly or indirectly collecting, recovering, or receiving payment or recovery with respect to any claim or demand that, under a plan of reorganization, is to be paid in whole or in part by a trust described in paragraph (2)(B)(i), except such legal actions as are expressly allowed by the injunction, the confirmation order, or the plan of reorganization.

(2)(A) Subject to subsection (h), if the requirements of subparagraph (B) are met at the time an injunction described in paragraph (1) is entered, then after entry of such injunction, any proceeding that involves the validity, application, construction, or modification of such injunction, or of this subsection with respect to such injunction, may be commenced only in the district court in which such injunction was entered, and such court shall have exclusive jurisdiction over any such proceeding without regard to the amount in controversy.

(B) The requirements of this subparagraph are that –

(i) the injunction is to be implemented in connection with a trust that, pursuant to the plan of reorganization –

(I) is to assume the liabilities of a debtor which at the time of entry of the order for relief has been named as a defendant in personal injury, wrongful death, or property-damage actions seeking recovery for damages allegedly caused by the presence of, or exposure to, asbestos and asbestos-containing products;

(II) is to be funded in whole or in part by the securities of 1 or more debtors involved in such plan and by the obligation of such debtor or debtors to make future payments, including dividends;

(III) is to own, or by the exercise of rights granted under such plan would be entitled to own if specified contingencies occur, a majority of the voting shares of –

(aa) each such debtor;

(bb) the parent corporation of each such debtor; or

(cc) a subsidiary of each such debtor that is also a debtor; and

(IV) is to use its assets or income to pay claims and demands; and

(ii) subject to subsection (h), the court determines that –

(I) the debtor is likely to be subject to substantial future demands for payment arising out of the same or similar conduct or events that gave rise to the claims that are addressed by the injunction;

(II) the actual amounts, numbers, and timing of such future demands cannot be determined;

(III) pursuit of such demands outside the procedures prescribed by such plan is likely to threaten the plan's purpose to deal equitably with claims and future demands;

(IV) as part of the process of seeking confirmation of such plan –

(aa) the terms of the injunction proposed to be issued under paragraph(1)(A), including any provisions barring actions against third parties pursuant to paragraph (4)(A), are set out in such plan and in any disclosure statement supporting the plan; and

(bb) a separate class or classes of the claimants whose claims are to be addressed by a trust described in clause (i) is established and votes, by at least 75 percent of those voting, in favor of the plan; and

(V) subject to subsection (h), pursuant to court orders or otherwise, the trust will operate through mechanisms such as structured, periodic, or supplemental payments, pro rata distributions, matrices, or periodic review of estimates of the numbers and values of present claims and future demands, or other comparable mechanisms, that provide reasonable assurance that the trust will value, and be in a financial position to pay, present claims and future demands that involve similar claims in substantially the same manner.

(3)(A) If the requirements of paragraph (2)(B) are met and the order confirming the plan of reorganization was issued or affirmed by the district court that has jurisdiction over the reorganization case, then after the time for appeal of the order that issues or affirms the plan –

(i) the injunction shall be valid and enforceable and may not be revoked or modified by any court except through appeal in accordance with paragraph (6);

(ii) no entity that pursuant to such plan or thereafter becomes a direct or indirect transferee of, or successor to any assets of, a debtor or trust that is the subject of the injunction shall be liable with respect to any claim or demand made against such entity by reason of its becoming such a transferee or successor; and

(iii) no entity that pursuant to such plan or thereafter makes a loan to such a debtor or trust or to such a successor or transferee shall, by reason of making the loan, be liable with respect to any claim or demand made against such entity, nor shall any pledge of assets made in connection with such a loan be upset or impaired for that reason;

(B) Subparagraph (A) shall not be construed to –

(i) imply that an entity described in subparagraph (A)(ii) or (iii) would, if this paragraph were not applicable, necessarily be liable to any entity by reason of any of the acts described in subparagraph (A);

(ii) relieve any such entity of the duty to comply with, or of liability under, any Federal or State law regarding the making of a fraudulent conveyance in a transaction described in subparagraph (A)(ii) or (iii); or

(iii) relieve a debtor of the debtor's obligation to comply with the terms of the plan of reorganization, or affect the power of the court to exercise its authority under sections 1141 and 1142 to compel the debtor to do so.

(4)(A)(i) Subject to subparagraph (B), an injunction described in paragraph (1) shall be valid and enforceable against all entities that it addresses.

(ii) Notwithstanding the provisions of section 524(e), such an injunction may bar any action directed against a third party who is identifiable from the terms of such injunction (by name or as part of an identifiable group) and is alleged to be directly or indirectly liable for the conduct of, claims against, or demands on the debtor to the extent such alleged liability of such third party arises by reason of –

(I) the third party's ownership of a financial interest in the debtor, a past or present affiliate of the debtor, or a predecessor in interest of the debtor;

(II) the third party's involvement in the management of the debtor or a predecessor in interest of the debtor, or service as an officer, director or employee of the debtor or a related party;

(III) the third party's provision of insurance to the debtor or a related party; or

(IV) the third party's involvement in a transaction changing the corporate structure, or in a loan or other financial transaction affecting the financial condition, of the debtor or a related party, including but not limited to –

(aa) involvement in providing financing (debt or equity), or advice to an entity involved in such a transaction; or

(bb) acquiring or selling a financial interest in an entity as part of such a transaction.

(iii) As used in this subparagraph, the term "related party" means –

(I) a past or present affiliate of the debtor;

(II) a predecessor in interest of the debtor; or

(III) any entity that owned a financial interest in –

(aa) the debtor;

(bb) a past or present affiliate of the debtor; or

(cc) a predecessor in interest of the debtor.

(B) Subject to subsection (h), if, under a plan of reorganization, a kind of demand described in such plan is to be paid in whole or in part by a trust described in paragraph (2)(B)(i) in connection with which an injunction described in paragraph (1) is to be implemented, then such injunction shall be valid and enforceable with respect to a demand of such kind made, after such plan is confirmed, against the debtor or debtors involved, or against a third party described in subparagraph (A)(ii), if –

(i) as part of the proceedings leading to issuance of such injunction, the court appoints a legal representative for the purpose of protecting the rights of persons that might subsequently assert demands of such kind, and

(ii) the court determines, before entering the order confirming such plan, that identifying such debtor or debtors, or such third party (by name or as part of an identifiable group), in such injunction with respect to such demands for purposes of this subparagraph is fair and equitable with respect to the persons that might subsequently assert such demands, in light of the benefits provided, or to be provided, to such trust on behalf of such debtor or debtors or such third party.

(5) In this subsection, the term "demand" means a demand for payment, present or future, that-

(A) was not a claim during the proceedings leading to the confirmation of a plan of reorganization;

(B) arises out of the same or similar conduct or events that gave rise to the claims addressed by the injunction issued under paragraph (1); and

(C) pursuant to the plan, is to be paid by a trust described in paragraph (2)(B)(i).

(6) Paragraph (3)(A)(i) does not bar an action taken by or at the direction of an appellate court on appeal of an injunction issued under paragraph (1) or of the order of confirmation that relates to the injunction.

(7) This subsection does not affect the operation of section 1144 or the power of the district court to refer a proceeding under section 157 of title 28 or any reference of a proceeding made prior to the date of the enactment of this subsection.

**Exhibit B**
**K&L Gates Alert from London**

## Prudential Assurance Company Ltd and others v PRG Powerhouse Ltd. and others

*High Court of Justice - [2007] EWHC 1002 (Ch) 1 May 2007*

### Introduction

In the eagerly anticipated Powerhouse decision, which was handed down on 1 May 2007, Mr Justice Etherton held in favour of the applicant landlords, who had claimed that they would be unfairly prejudiced by the terms of a company voluntary arrangement ("CVA") proposed by their tenant, PRG Powerhouse Limited ("Powerhouse"). This decision was not only an important success for the particular landlords, but also provides important clarification to a controversial area of law. Landlords should now be reassured that any CVA proposed by their tenants which seeks to terminate guarantees given by the tenants' parents or associates will be ineffective.

### Background and the CVA

In September 2003 Powerhouse acquired a U.K.-based electrical retailing business, which operated from a number of high street stores and superstores. As is common, a number of the landlords of these stores took parent guarantees from PRG Group Ltd ("PRG") to support Powerhouse's lease obligations.

The business was not a success. A restructuring programme was introduced whereby Powerhouse would close 35 of its stores (the "Closed Premises"), retaining the 53 stores which would enable the company to trade profitably. The directors also proposed a CVA which would compromise the rights and obligations of certain classes of creditors (the "Scheme Fund Creditors"), but would leave all other creditors unaffected. The Scheme Fund Creditors comprised employees, landlords, local authorities and other creditors of the Closed Premises. Powerhouse's parent, PRG, was to provide £1.5m to fund the CVA which would result in a dividend of 28p in the £ to the Scheme Fund Creditors. In return, the Scheme Fund Creditors would release their claims against Powerhouse. An uncontroversial proposal so far. But importantly, and unusually, the CVA also provided that any guarantees or indemnities provided by PRG in respect of the Closed Premises would also be released.

The ramifications of the Powerhouse CVA raised serious concerns in the institutional property market. The CVA proposal effectively rendered worthless the covenants and guarantees provided by the tenant's parent, in the precise circumstances envisaged by those guarantees, namely, the tenant's insolvency. Had the Powerhouse CVA succeeded, other retailers could have used CVAs as mechanisms to rid debtor companies of their guaranteed liabilities. Furthermore, it was estimated that some £38bn could have been wiped off commercial property values (c10% of U.K. leased property) had the applicant landlords' challenge failed.

### Considerations

The basis of the landlords' claim was twofold. Could a CVA proposed by their tenant operate to release guarantees provided by a third party, namely PRG? If so, the landlords claimed that they were unfairly prejudiced by the terms of the CVA.

Mr Justice Etherton held that the reference to an "arrangement of its affairs" in s.1 of the Insolvency Act 1986 (the "Act") was not broad enough to enable the CVA to release PRG's liability under the guarantees directly. This is because it is the company and not any third party, which has the benefit of, and is able to enforce, the rights and obligations conferred by a CVA. However, the judge confirmed it is possible for a CVA to dictate that a creditor cannot enforce an obligation of a third party to that creditor, which would allow the third party to make a subrogated claim against the debtor company. In other words, in principle, it would be permissible for the CVA to state that Powerhouse could oblige the landlords to desist from claiming against PRG under the guarantees provided.

Mr Justice Etherton then examined particular clauses of the CVA in order to determine whether there was any evidence of prejudice. Any such prejudice must be unfair. Section 6(1)(a) of the Act provides a right to challenge the CVA, or the manner in which it was approved, if it unfairly prejudices the rights of a creditor of the company.

The judge reiterated that, although the terms of a CVA might be prejudicial to a creditor, demonstrating prejudice alone is not enough; such prejudice must also be unfair. There is no one test for judging fairness, but Mr Justice Etherton invoked two tests: a "vertical" comparison (with the position on a winding-up) and a "horizontal" comparison (with the other creditors or class of creditors). The vertical test has been applied in a number of key cases, including Re T&N Ltd [2004] EWHC 2361 (Ch). In that case, Mr Justice David Richards said it would be unlikely that a CVA would be sanctioned as an alternative to a winding-up if the CVA was likely to result in some or all creditors receiving less than they would in a winding-up. In some cases, certain classes of creditors may be treated differently from others to ensure fairness. For example, in order to secure the continuation of the company's business underpinning the CVA, it may be necessary to pay suppliers in full (SISU Capital Fund Ltd v Tucker [2005] EWHC (Ch) and the Garuda case [2001] EWCA Civ 16960). Such differential treatment must not, of course, be deemed to be unfairly prejudicial.

The horizontal test compares the position of the applicant landlords as against that of the other creditors of Powerhouse. The T&N case illustrated the similarity of the underlying test of fairness for both CVAs and schemes of arrangement pursuant to s.425 of the Companies Act 1985 (a "Scheme"). In a CVA, all creditors (save for secured creditors) meet and vote on a CVA at one meeting, whereas in a Scheme different classes of creditors meet and vote separately, so that any one class of creditors can block the Scheme. The concept of fairness is, however, common to both Schemes and CVAs when analysing whether an intelligent and honest man in the class concerned would have voted in favour of the Scheme or CVA.

**Conclusions**

With the above in mind, Mr Justice Etherton held that the Powerhouse CVA was unfairly prejudicial to the applicant landlords. The CVA would have left the landlords in a worse position than without or as compared to a liquidation:

The guarantees were of value and would have been enforceable both now and in the future. In support of that contention, PRG was undoubtedly solvent and was able to meet its guarantee obligations; PRG was funding the CVA and Powerhouse could only survive with the support of PRG.

Removing the landlords' right to enforce the guarantees substantially weakened their bargaining strength in persuading PRG to compensate them for the loss of that right. The landlords were to receive nothing extra for the loss of the benefit of the guarantees, and the 28 pence dividend calculation had failed to take into account the issue of the benefit and value of the guarantees.

Comparison with the other classes of creditors also supported the contention that the landlords had been unfairly prejudiced:

The landlords' (and other Scheme Fund Creditors') claims were to be discharged at a fraction of their value, yet the non-Scheme Fund Creditors' were to be paid in full. Although this would not be a unique outcome, in this case, on a winding-up, the landlords would have benefited from the valuable guarantees whereas other creditors would have received nothing.

In a winding-up, therefore, the landlords would suffer little or not at all (by virtue of their parent guarantees). Yet in the proposed CVA, the landlords would suffer most by virtue of their valuable guarantees (which improved their position over all other unsecured creditors) being afforded nil value.

Mr Justice Etherton described the resulting CVA as providing an "illogical and unfair result". Such a result could not be obtained in a Scheme, since the landlords would have formed a class of their own. Moreover, the creditors who were being paid in full would not have been entitled to vote in a Scheme. So the creditors who had absolutely everything to gain from the CVA far outnumbered and were able to "cram-down" the landlords who were significantly disadvantaged by it. That, in Mr Justice Etherton's mind, was unfairly prejudicial and not contemplated by the legislation.

The commercial property industry will be relieved that this judgment has brought clarity to this issue and has reaffirmed the value of parent company guarantees. The judgment is also a reminder to debtors and insolvency professionals of the limitations of a CVA. If it is proposed that a class or classes of creditors will be treated substantially differently from others, a Scheme may be more appropriate, to provide each class of creditors with the opportunity to vote on the proposal. Without such transparency, the risk of an unfair prejudice challenge will be likely.

**Exhibit C**
**Berlin Memorandum**

## LIABILITY AND RELEASE OF SUCH LIABILITY OF DIRECTORS UNDER A PLAN OF REORGANIZATION

This memorandum will look at three specific questions: the liability of directors in German insolvency proceedings, a possible release of their duties and obligations with regard to a German plan of reorganization and, finally, the recognition of a U.S. law plan of reorganization under German Law.

With regard to these specific questions, we are not aware of any particularly relevant judicature. Since the German law system is not a case law system, any relevant jurisdiction would not be precedent-setting, but might just give a hint to a court's opinion.

The German Insolvency Code (*Insolvenzordnung - InsO*) does not provide specific provisions for the release of directors and officers in a general insolvency proceeding (*Insolvenzverfahren*) or an insolvency plan procedure (*Insolvenzplanverfahren*), but a release from certain obligations or liabilities can be granted under certain conditions. However, as the conditions for personal liability of officers and directors are strict, the general release from liabilities of officers and directors in connection with the insolvency of a company is in fact rather seldom.

Finally, we have examined the third question of whether a German director of a U.S. company for which a plan of reorganization has been confirmed can be held liable in Germany.

### 1. LIABILITY OF DIRECTORS IN INSOLVENCY PROCEEDINGS UNDER GERMAN LAW

First of all, we would like to give a brief overview on the general legal provisions on civil and criminal liability risks directors of German limited liability companies *(Gesellschaft mit beschränkter Haftung – GmbH)* are facing in connection with insolvency proceedings. Similar but not identical rules exist in respect to the management board *(Vorstand)* of a corporation *(Aktiengesellschaft)*.

### 1.1 Civil liability

When considering the liability risks directors of German limited liability companies are facing in insolvency proceedings, one must differentiate between a possible liability to the company (internal liability) and to the company's creditors (external liability).

(a) Internal Liability

Directors may be liable in connection with insolvency proceedings to the company if they either violate their duties under sec. 43 paragraph 2 German Limited Liability Company Act (*GmbHG*) or sec. 64 paragraph 2 *GmbHG***.** Any claims arising out of the internal liability (vis-à-vis the company) can be asserted by the insolvency administrator.

(i) Liability under sec. 43 paragraph 2 *GmbHG*

Sec. 43 *GmbHG* obligates directors to conduct the business with the diligence of a responsible businessman and sets out liability for damages due to a breach of such general responsibilities. With respect to insolvency proceedings, one element of these general responsibilities is that directors have the duty to identify economic difficulties at an early stage and to act accordingly. For example, courts in Germany have ruled that directors are liable for damages to the company due to a delayed or defaulted filing of insolvency proceedings under sec. 43 paragraph 2 *GmbHG*, if they acted negligently. No liability can arise if a delayed filing of insolvency proceedings is due to a shareholder's directive, e.g., a shareholders' resolution deciding not to file for insolvency.

Whether or not it is possible to exclude directors from a liability arising out of a breach of the duties set out in sec. 43 *GmbHG* is heavily disputed in legal literature and jurisprudence and depends in fact on the specific facts of each case. A waiver of the claim by the shareholders is generally possible, provided, however, that the assertion of the claim is not necessary to settle the creditor's claims against the company. The limitation period for such claims is five years.

(ii) Liability under sec. 64 paragraph 2 *GmbHG*

In order to ensure the equal distribution of the insolvency estate among the creditors, sec. 64 paragraph 2 *GmbHG* - being one of the main objectives of insolvency proceedings if the business cannot be continued - holds directors liable for all payments occasioned after the event of over-indebtedness or illiquidity. However, this does not apply to payments made with the diligence of a responsible businessman. This includes payments that do not affect the insolvency estate or are necessary in order to execute the insolvency proceedings such as salaries, wages or rent. The directors bear the burden of proof regarding the legitimacy of the payments. In order to be liable for damages caused by payments executed after the event of over-indebtedness or illiquidity, directors must have acted negligently in respect to the over-indebtedness or illiquidity of the company. The claim for damages includes the amount of the unrightful payment less the consideration that remains with the insolvency estate. The company and, after the institution of the insolvency proceedings, the insolvency administrator are entitled to assert the claim. The company cannot effectively waive this claim, but this restriction may not apply to the insolvency administrator. The administrator has the right to waive the claim (usually with the consent of the insolvency court or with the consent of creditors at a creditors' meeting (*Gläubigerversammlung*) or through the creditors' committee (*Gläubigerausschuss*)). The administrator may also negotiate a settlement with the directors.

It is disputed whether or not such settlement or waiver is effective without consideration or if such settlement or waiver obviously runs contrary to the purpose of the insolvency proceedings. The limitation period for such claims is five years.

(b) External Liability

The liability arising from sec. 823 paragraph 2 German Civil Code (*BGB*) in connection with sec. 64 *GmbHG* is of particular importance in this context. Under these provisions, directors are liable for damages to the creditors if they neglect to file for insolvency in the event of over-indebtedness or illiquidity without undue delay, and, in any event, at least within three weeks. In order to be liable, directors must have at least acted negligently. All creditors are entitled to damages as long as the claims originated before the commencement of insolvency proceedings. Yet another differentiation is necessary to determine the scope of liability. Those creditors who obtained their position before the insolvency proceedings have been filed are considered as so-called old creditors; the ones that obtain their position after this point are so-called new creditors. Old creditors are entitled to damages limited to the amount by which the insolvency estate of the company was reduced due to the delay in the filing of the insolvency proceedings (*Quotenschaden*). For a long time the same was true for new creditors, but recently the German Federal Court of Justice (*BGH*) has changed its legal opinion. New creditors now have to be compensated as if they had never contracted with the company (*Vertrauensschaden*).

Although every old creditor has an individual claim for damages, it is acknowledged that pursuant to sec. 93 paragraph 5 German Stock Corporation Act (*AktG*) the insolvency administrator asserts the damages for the insolvency estate on behalf of the creditors. This, of course, is only true if insolvency proceedings are being instituted. New creditors, by contrast, may assert their individual damages by themselves. The limitation period for such claims is five years. In addition to the abovementioned specialized claim for damages, other contractual claims could be raised by creditors, as the case may be. Special rules or procedures that would exculpate or release directors from their external liability with respect to their involvement with insolvency proceedings have not been promulgated.

### 1.2 Criminal liability

Directors face a prison sentence of up to three years or a fine under sec. 84 paragraph 1 Nr. 2 *GmbHG* if they fail to file for insolvency in the event of over-indebtedness or illiquidity as required by sec. 64 *GmbHG*, provided, however, that they have acted intentionally. In contrast to the civil liability under sec. 823 paragraph 2 *BGB*, 64 paragraph 2 *GmbHG*, directors are given the benefit of the doubt in respect to the fulfillment of the constituent facts. If the prosecution fails to prove an intentional behavior but can establish negligence, the prison sentence will be reduced to a maximum of one year or a fine.

## 2. RELEASE OF DIRECTORS IN CONNECTION WITH A PLAN OF REORGANIZATION UNDER GERMAN LAW

The German Insolvency Law does not explicitly provide for a release of directors and officers of their duties or obligations in connection with a plan of reorganization. Neither does an injunction or stay under a confirmed plan of reorganization exist. However, in the following discussion we will set out an assessment of the possibilities of a release from such duties or obligations under German Law.

2.1 With the institution of the insolvency proceedings, the insolvency administrator is entitled to take all dispositions on behalf of the company (sec. 80 Insolvency Act (*InsO*)). Of course, this does include claims of the company against its directors (internal liability). The administrator is compelled to act in the interest of the creditors in the insolvency proceedings. He is supervised by the insolvency court and by the creditors' committee. However, this does not mean that a disposition violating the intention of the insolvency proceedings is invalid as such. In fact, such dispositions would generally only constitute a liability of the administrator to sanction his malpractice. This means that he could effectively release directors from their liability to the company. On the other hand, there is a principal agreement that not all dispositions may be valid as some are suffering from grave errors. Therefore, in every case in which the other party knows or it is at least obvious to the other party that the disposition violates the duties of the insolvency administrator, such disposition is invalid. For this reason, a release of directors by an administrator is highly unlikely as it would either be considered to be invalid or the administrator might be personally liable for such a release. Administrators may limit possible claims against directors in a negotiated settlement only if such settlement is in the best interest of creditors. Such negotiation would typically happen in an insolvency plan procedure. But in order to be valid it could be necessary even for such settlement to be approved by the creditors' meeting or committee, if such settlement would be considered to be an especially important legal act ("*besonders bedeutsame Rechtshandlung*") under sec. 160 *InsO*.

2.2 The foregoing is similarly true for claims arising from the liability of directors under sec. 823 paragraph 2 German Civil Code (*BGB*) in connection with sec. 64 *GmbHG* (external liability). Those claims are being asserted by the insolvency administrator pursuant to sec. 92 *InsO* for the insolvency estate on behalf of the old creditors. As the old creditors are still the rightful claimants, each creditor can individually, in respect to their proportion of the claim, release the directors from their liability pursuant to the general rules set out in the *BGB*. In addition to this release by agreement, the insolvency administrator may compromise with the directors, if this is in the interest of the creditors and does not violate the intention of the insolvency proceedings as explained above. This does not, however, include settlements for other individual liabilities of directors to creditors, but is limited to these particular circumstances.

## 3. RECOGNITION OF A CONFIRMED PLAN OF REORGANIZATION UNDER U.S. LAW BY GERMAN COURTS

The German Insolvency Law contains certain provisions (sec. 335 et seq. *InsO*) with regard to the recognition of foreign insolvency proceedings under German Law. In general, under these provisions, international insolvency proceedings are governed by the national law of the country where the insolvency proceedings are instituted. Hence, insolvency proceedings and their legal effects under U.S. Law are generally recognized under German Law. A provision that especially relates to the recognition of a release of directors or officers under a foreign plan of reorganization does not exist, but the above-mentioned general provision with regard to the recognition of foreign insolvency proceedings includes the recognition of foreign plans of reorganization. Thus, it is arguable, subject to public policy and any other applicable legal authority under German Law, that a release of a director or officer under a U.S. plan of reorganization should be honored under German Law.

**Exhibit D**
**China Memorandum**

**DATE:** May 4, 2008

**RE:** Brief Introduction of China's New Bankruptcy Law

The new *Enterprise Bankruptcy Law of PRC* (the "New Bankruptcy Law") was adopted on August 27, 2006 and has taken effect from June 1, 2007, superseding the 1986-enacted *Enterprise Bankruptcy Law (Trial)* (the "1986 Law"). The New Bankruptcy Law offers for the first time a unified regime applicable to all types of enterprises ("Enterprise") in China and also provides much clearer procedures for insolvent enterprises to restructure or exit the market. Below is a brief introduction of the key provisions of the New Bankruptcy Law.

### *1. Applicability*

The New Bankruptcy Law applies to all enterprises[1] with legal person status, including both privately-owned companies and state-owned enterprise, foreign enterprises and domestic companies, listed companies and non-listed companies, limited liability companies and companies limited by shares, while the 1986 Law applied only to state-owned enterprises. The New Bankruptcy Law does not apply to insolvent partnerships or individuals. At present, there is no personal bankruptcy system in China.

### *2. Commencement of Bankruptcy Proceedings*

*Three Types of Bankruptcy Proceedings*

The New Bankruptcy Law offers three types of bankruptcy proceedings: liquidation (bankruptcy), restructuring and compromise.

*Petition*

Under the New Bankruptcy Law, a creditor or the Enterprise may petition to the court to bankrupt or restructure the Enterprise. If a creditor has petitioned for the bankruptcy of an Enterprise, the Enterprise or a shareholder or shareholders whose capital contribution accounts for more than 10 percent of the Enterprise's equity interests may petition to the court for restructuring, prior to a declaration of bankruptcy. However, only the Enterprise may apply to the court for approval of compromise with creditors.

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[1] The New Bankruptcy Law also provides that with regard to financial institutions such as banks and insurance companies, the State Council may adopt supplementing rules in accordance with the New Bankruptcy Law and other relevant laws. Such supplementing rules have not yet been adopted.

*Petition Basis*

Under the New Bankruptcy Law, an Enterprise may petition for the liquidation, restructuring or compromise when it meets two criteria: (1) the Enterprise is unable to pay its debts when due; and (2) the Enterprise's assets are not sufficient to repay all of its debts. A creditor may petition for the restructuring or the liquidation of the Enterprise when the Enterprise is unable to pay its debts when due.

Once the court assumes the jurisdiction and before it declares the Enterprise bankrupt, it may reject the petition any time if it decides that the Enterprise does not meet both of the criteria, i.e., (1) the Enterprise is unable to pay its debts when due; and (2) the Enterprise's assets are not sufficient to repay all of its debts.

The New Bankruptcy Law further provides that restructuring may be conducted when the Enterprise is "clearly insolvent." However, there is no further clarification on what it means.

*Acceptance of Petition and Suspension of Proceedings*

Upon the acceptance of the petition by the court (not the date of filing of the Petition), the New Bankruptcy Law allows the court to impose a temporary stay on all ongoing civil proceedings and arbitrations relating to the Enterprise until the administrator takes over the management of the Enterprise's businesses and assets. Furthermore, there is a fifteen (15) day period between the filing of the petition and its acceptance or rejection by the court (such period is also subject to extension of another fifteen (15) days upon approval by a higher court).

Upon the acceptance of the petition by the court, all subsequent civil proceedings can only be initiated with the court who assumes the jurisdiction for the petition.

### ***3. Administrator***

An administrator is appointed by the court upon the acceptance of the petition. As to who can act as "administrator," the New Bankruptcy Law is not clear and only provides that the "liquidation committee" (composed of personnel from relevant departments and agencies), or an intermediary organization established in accordance with the law (such as a law firm, accounting firm, or bankruptcy liquidation firm) may act as an administrator.

It further provides that the court may also appoint relevant personnel of the Enterprise who possesses relevant professional knowledge and with relevant qualifications as the administrator.

The New Bankruptcy Law does not give creditors a voice in choosing the administrator. But the law provides that the creditors can request the court to dismiss the administrator and designate a new one if they believe the administrator is unable to fairly and lawfully carry out its duties or there are other circumstances that would prevent the administrator from carrying out its duties competently.

The remuneration for the administrator remains unaddressed in the New Bankruptcy Law and is referred to the subsequent Supreme Court's rules which have not yet been adopted.

### *4. Enterprise's Property and Creditor's Meeting*

*Enterprise's Duties in Preserving its Property*

The New Bankruptcy Law imposes stringent duties to an Enterprise on preservation and handover of the assets/books of the Enterprise. In addition, an Enterprise is required to cause its relevant personnel (including the legal representative of the Enterprise and, as the case may be, financial and other operational managers) to be present at the creditors' meeting and truthfully answer all questions from the administrators, creditors, and the court. Such personnel shall not leave his or her place of residence without the court's permission and is prohibited from taking any director, supervisor or executive position for any other entity once the bankruptcy proceeding has been commenced.

*Prevention of Deceptive Bankruptcy*

The administrators, upon petitioning to the court, have the power to undo certain transactions involving property of the Enterprise taken within one (1) year before the court accepts the bankruptcy petition. These include gifts, transfers at an obvious undervalue, security given for unsecured debts, early repayment of debts that have not fallen due, and abandonment of rights to repayment.

Similar provisions exist to void transactions that occurred within six (6) months of the acceptance of the bankruptcy petition when the Enterprise was insolvent and continued to pay creditors. In such circumstances, the administrator may petition to the court to revoke these transactions.

Certain acts involving the Enterprise's property are simply invalid. Those acts include the concealing or transferring of property to avoid repayment of debts and the fabrication of debts or acknowledgment of debts that are not genuine.

The New Bankruptcy Law empowers administrators to recover property obtained as a result of such transactions.

Other related provisions include the ability to require shareholders to fully pay their share capital, the barring of Enterprises from making distributions to their shareholders during restructuring unless approved by the court, and the recovery of irregular income and corporate property improperly acquired by directors, supervisors, and senior managers of the Enterprise.

*Creditors and Creditors' Meeting*

The New Bankruptcy Law provides for the establishment of creditors' meetings and creditors' committees. The creditors' meetings allow creditors to participate in the following activities (however, the secured creditors may not vote on matters relating to items (g) and (j) below, unless they waive their right to priority in relation to the secured property):

(a) verifying creditors' claims;
(b) petitioning to the court to replace the administrator and examine its expenses and remuneration;
(c) supervising the administrator;
(d) electing and replacing members of the creditors' committee;
(e) deciding on the continuation or cessation of business of the Enterprise;
(f) adopting restructuring plans;
(g) adopting compromise agreements;
(h) adopting plans for the management of the property of the Enterprise;
(i) adopting plans for the sale of the Enterprise's assets; and
(j) adopting plans for the distribution of property in bankruptcy.

A resolution will be passed by a majority of the creditors present at the meeting holding fifty (50) percent or more of the total unsecured claims, unless a higher percentage is required by the other provisions of the New Bankruptcy Law (e.g., adoption of restructuring plan and settlement as described in more details in 5 and 6 below). Resolutions passed at these meetings are binding on all creditors (other than secured creditors), though any creditor may, within fifteen (15) days of the passing, ask the court to nullify resolutions that violate legal provisions or harm that creditor's interests.

The creditors' meeting may also appoint a creditors' committee of no more than nine (9) members and delegate some of its powers to the committee, however, such creditors' committee must include a representative of the workers' union of the Enterprise.

### *5. Restructuring*

*Commencement and Period of Restructuring*

A creditor or an Enterprise may directly petition to the court to restructure the Enterprise. When a creditor has already petitioned for the bankruptcy of an Enterprise, the Enterprise or a shareholder holding one-tenth or more of the equity interests in the Enterprise may also file an application to restructure the Enterprise. The restructuring period starts from the date on which the court approves the restructuring until the termination of the restructuring proceedings. During the restructuring, upon the court's approval, the Enterprise may, under the supervision of the administrator, manage property and business of the Enterprise by itself. However, no further clarification has been provided in the Bankruptcy Law as to what criteria the court will adopt to approve the Enterprise managing its property and businesses.

*Formulation, Approval, and Implementation of a Restructuring Plan*

Once the court orders the restructuring of the Enterprise, a restructuring plan must be submitted by the Enterprise or the administrator (depending on who the court approves for the management of property and business of the Enterprise during the restructuring period) to both the court and the creditors' meeting within six (6) months from date of order. A three-month extension is available on legitimate grounds. The court is then obliged to convene a creditors' meeting to vote on the plan within thirty (30) days from the submission of the plan.

The New Bankruptcy Law provides distinct class of creditors. While the court has the ultimate authority to approve a restructuring plan, subject to some quite detailed guidelines, the main aim of the New Bankruptcy Law is that the restructuring plan has to be approved by all classes of creditors. Shareholders can only vote in respect of the restructuring plan if their rights will be adjusted in the restructuring plan.

The New Bankruptcy Law categorizes creditors into different classes: (1) secured creditors; (2) debt arising out of entitlements from work such as wages, medical and disability subsidies, and social insurance; (3) taxes; and (4) unsecured creditors. There is an option for the court to establish a subclass of creditors having small claims within the class of unsecured creditors. The creditors shall cast their votes by their distinct classes on the draft restructuring plan. A resolution is passed when a simple majority of the creditors attending the meeting of a particular class of creditors agree to the proposed plan and when the amount of the debt they hold exceeds two-thirds of the total of the debts in the same class.

The restructuring plan may be approved by the court even if some classes refuse to vote for or against it, provided that secured creditors, workers, and the tax authorities are fully paid, unsecured creditors are no worse off than if the Enterprise goes to liquidation, and the plan is practicable. Once a plan is approved, it becomes binding on the Enterprise and all creditors.

The Enterprise is responsible for the implementation of the plan, once it has been approved by the court. At this point, if the administrator is in control of the Enterprise's affairs, it must hand over all property to the Enterprise. The administrator's role is to then supervise the implementation of the plan. The Enterprise is required to report to the administrator on implementation throughout this supervision period. Finally, when the supervision period has expired, the administrator submits a supervision report to the court and its duties terminate on that date.

### *6. Compromise Agreement*

While the New Bankruptcy Law makes no explicit mention of other alternative procedures such as debt write-offs, rescheduling, and debt-equity conversions, provisions related to compromise do exist that make these possible. Once the Enterprise and creditors have arrived at a compromise agreement, only the Enterprise may apply to the court for approval of the compromise. The Enterprise may also apply for approval of compromise after the court has accepted jurisdiction over the matter but before a declaration of bankruptcy. Once the requisite approvals have been obtained from the court, the creditors in a creditors' meeting must vote on the compromise. A resolution adopting the compromise must be agreed to by a majority of the creditors attending a creditors' meeting, and the amount of the debt they represent must exceed two-thirds of the total of the unsecured debts. Once the creditors' meeting and the court have approved a compromise agreement, it becomes binding on all parties (other than the secured creditors). The secured creditors must abandon their priority repayment right with respect to the security (and then become unsecured creditors) in order to vote on compromise agreements.

Once the court allows the compromise, the secured creditors can exercise their right with regard to their security. If an Enterprise is unable to implement the compromise agreement, the court may, upon the request of the creditors, order the termination of the compromise agreement and declare the Enterprise bankrupt.

The New Bankruptcy Law also provides that the creditors' rights against certain third parties (the guarantor of the Enterprise or any other co-debtors with joint and several liabilities) shall not be affected by the compromise agreement.

### *7. Payment Priorities and Recourse*

Under the 1986 Law, employees' claims are paid first before those of all creditors (secured and unsecured). The New Bankruptcy Law, however, preserves the priority of secured creditors in relation to their secured assets, generally.[2]

The New Bankruptcy Law provides additional recourse for creditors in bankruptcy proceedings within two years of the conclusion of the bankruptcy procedure. During that period, if it is discovered that additional property exists - for instance, property that has been transferred to the directors, concealed, or sold at an undervalue - the creditors may petition the court to effect an additional distribution.

It is expressly provided that, after the conclusion of a bankruptcy procedure, creditors may still pursue guarantors of the Enterprise and other co-debtors for amounts owed under the guarantees, as one would expect. However, amounts paid under the guarantee will not be recoverable by guarantors against the Enterprise after the bankruptcy has concluded.

### *8. Cross-border Insolvency*

Bankruptcy proceedings initiated under the New Bankruptcy Law are stated to be binding on the Enterprise's property and assets worldwide.

The court may also recognize and enforce legally valid, foreign bankruptcy court judgments and rulings involving an Enterprise's property and assets located within China. However, China law requires that a treaty or principle of reciprocity in bankruptcy proceedings (or judgments in them) exists and that the petition does not contravene basic principles of Chinese law, prejudice the sovereignty, security, and public and social interest of China, or hurt the legitimate rights and interests of creditors in China.

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[2] Under the New Bankruptcy Law, as a general principle, the employees are paid before the unsecured creditors are paid, but after the secured creditors are paid out of the security. However, there is one exception: if the employees' claims accrued prior to August 27, 2006 (the date on which the New Bankruptcy Law was enacted), employees will still be paid before all other creditors, including both secured and unsecured creditors, are paid.