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NEWS

Policy-related complexities in parallel, cross-border insolvency and arbitration proceedings

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L to r: Heverin, Peet, Woods, Goins and Guillet (Credit: Vinson & Elkins)

"A party seeking to arbitrate claims against a debtor in a US bankruptcy proceeding faces an uphill climb": Vinson & Elkins restructuring counsel **Kevin Heverin** in London and senior associate **Jessica Peet** in New York, team up with international arbitration partner **Louise Woods**, counsel **Adrianne Goins** and trainee solicitor **Elena Guillet**, to explore some of the practical issues stemming from different policy considerations behind insolvency and arbitration laws across Europe and the US.

More than a third of the world's population is under lockdown to slow the spread of covid-19. The virus and these responsive measures have heavily disrupted lives, communities, and healthcare systems. Many businesses have been forced to change their operations. Covid-19 is rapidly pushing companies to

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operate in new ways, and the resilience of systems is being tested as never before. The substantial challenges brought by the pandemic, including breaks in business continuity, sudden changes in volume, drops in revenue and decreased workforce productivity, expose a growing number of businesses to financial difficulties, with a real risk of insolvency or bankruptcy.

For parties conducting arbitral proceedings during or immediately after the covid-19 pandemic, the potential insolvency of an award debtor will become a real concern. This insight explores the effects of parallel insolvency and arbitral proceedings and the practical issues that a claimant should consider when dealing with an insolvent respondent, particularly in cross-border disputes. These over-arching issues stem from the different policy considerations behind arbitration and insolvency laws in various jurisdictions. Issues for parties and counsel to consider include the potentially conflicting policy objectives of arbitration and insolvency laws, the priority that insolvency proceedings place on different types of debt, and the potential for a stay of arbitration proceedings.

A party in international arbitral proceedings could become subject to insolvency proceedings before the start of arbitration, during arbitral proceedings, or after an award is given. In the current economic climate, it is crucial to consider the interaction of insolvency with arbitration, on both the substantive and procedural levels.

Insolvency laws worldwide have different policy objectives to arbitration. The latter aims to uphold arbitration agreements and to promote certainty in commercial transactions. Insolvency laws on the other hand focus on the reorganisation of the debtor to the extent possible and providing it with a fresh start, and where a company cannot be rescued, on the equality of creditors and a centralisation of claims. Procedures vary too. Some insolvency statutes provide for a stay of ongoing proceedings, though there is some debate as to whether the definition of “proceedings” includes arbitration.

A prominent cross-border European dispute and key aspects of US and English approaches demonstrate the types of risks encountered by parties when parallel arbitration and insolvency proceedings meet.

Vivendi – Elektrim highlights the challenges

The dispute between French media conglomerate Vivendi and Polish group Elektrim highlights the challenges that arise when arbitration proceedings are taking place in one country and insolvency proceedings are taking place in another.

In 2003, a dispute arose involving Vivendi Universal, Elektrim, and Deutsche Telecom about ownership rights in the Polish telecoms company, Telco. Deutsche Telecom initiated arbitral proceedings in the Vienna Court of

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Arbitration against Telco and Elektrim, and in 2004, the Vienna Court concluded that the transfer of certain shares to Telco was ineffective. In 2005, Vivendi commenced arbitral proceedings under the London Court of International Arbitration (LCIA) rules against Elektrim, claiming that Telco still owned or was entitled to the shares. The following year, Vivendi and Elektrim commenced arbitration proceedings against Deutsche Telecom in Switzerland under the International Chamber of Commerce (ICC) rules for the alleged breach of a settlement agreement regarding ownership of the shares. (See the further reading list at the end of the article for full case references.)

Meanwhile, in August 2007, Elektrim was declared bankrupt in Poland. Elektrim requested the termination of both then-ongoing arbitral proceedings based on article 142 of the Polish Bankruptcy and Restructuring Law, which provided that if a party to an arbitration agreement was declared bankrupt, all arbitration proceedings pertaining to the bankrupt party were discontinued.

The arbitral tribunal in the LCIA proceedings analysed article 142 under the European Insolvency Regulation (EIR) and characterised the application of the Polish law as procedural, not substantive. The court, therefore, held that there was nothing in English domestic law that would prevent the arbitration from continuing. However, in the ICC arbitration, the Swiss arbitral tribunal considered the issue to be substantive. It concluded that, due to the application of Polish law, Elektrim had no legal capacity to participate in the proceedings, and the tribunal terminated the proceedings.

On 1 January 2016, a new Polish Bankruptcy Law came into force. The new law states that a declaration of bankruptcy will no longer entail the discontinuation of ongoing arbitration proceedings, putting an end to the disparate approaches to procedural and substantive issues. The new Bankruptcy Law ensures there should not be similar disparities in future arbitrations with parallel Polish bankruptcy proceedings. Nevertheless, inconsistencies remain in how courts resolve conflicts between arbitration proceedings and parallel foreign or domestic insolvency proceedings.

The approach in US Bankruptcy Courts

In the United States, the federal courts must reconcile the public policy interests that underlie bankruptcy and arbitration legislation. Section 362 of the US Bankruptcy Code automatically stays pre-bankruptcy claims against the debtor, including litigation claims, and the bankruptcy court has broad jurisdiction over the debtor's estate. The Federal Arbitration Act (FAA) reflects congressional policy to enforce valid arbitration agreements. While the US Supreme Court has consistently recognised the importance of the policy underlying the FAA, the court has not addressed the conflict that can arise between the two statutes when a party enters into a valid and binding arbitration agreement and

subsequently seeks to reorganise through Chapter 11 of the US Bankruptcy Code.

Due to the application of the automatic stay on all claims, a party desiring to commence arbitration against a debtor in a Chapter 11 bankruptcy proceeding must seek relief from the bankruptcy court. A central issue in a US bankruptcy court's decision to permit arbitration to proceed under a valid and binding arbitration provision is whether the dispute is considered "core" under US bankruptcy law. Although the legal test varies by jurisdiction, a matter is generally viewed as "core" if it implicates rights that arise exclusively under the US Bankruptcy Code. The statute provides a non-exhaustive list of examples of such "core" matters, including orders to sell property or to recover fraudulent conveyances. In contrast, a "non-core" matter is one that involves the parties' pre-bankruptcy relationship and does not involve rights created by the US Bankruptcy Code. If the issue is "non-core," bankruptcy courts typically do not have discretion to prevent arbitration under valid and binding arbitration provisions.

A 2017 bankruptcy court decision in the case of former brokerage firm MF Global Holdings highlights the significance of this distinction for parties seeking to enforce arbitration provisions in US bankruptcy courts.

The bankruptcy plan administrator commenced litigation in the bankruptcy court against Bermuda-based insurer Allied World Assurance Company, to enforce coverage under a liability policy on excess errors and omissions issued prior to the bankruptcy filing. In response, Allied World sought to compel arbitration of the dispute in Bermuda in accordance with the terms of the policy. First, the bankruptcy court concluded that a plain reading of the broadly phrased policy evidenced the parties' agreement to arbitrate any and all disputes related to the policy. Having found the provision valid and binding, the bankruptcy court then evaluated whether Congress intended the claims at issue to be arbitrable. To reconcile the competing interests of the US Bankruptcy Code and the FAA, the court considered whether the dispute involved a matter "core" to the Bankruptcy Code. Although the dispute involved the administration of estate assets and potentially implicated previous bankruptcy court orders, the bankruptcy court ultimately concluded that the matter was "non-core", noting that the funds at issue were relatively small in the context of the case and that the dispute pertained almost exclusively to the pre-petition relationship of the parties. Accordingly, the bankruptcy court held that MF Global Holdings was required to arbitrate the insurance dispute in Bermuda.

Although Allied World's success in compelling arbitration demonstrates that it is possible, as a practical matter, a party seeking to arbitrate claims against a debtor in a US bankruptcy proceeding faces an uphill climb. This case presented several unique factors, including that Allied World sought arbitration against MF Global Holdings after the key issues in the bankruptcy proceeding

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had been resolved, and the claims involved a relatively small amount of funds in the context of the case. Early in a bankruptcy proceeding, the US Bankruptcy Code's policy of providing the debtor with a breathing spell weighs against compelling arbitration. Likewise, with more significant assets at issue, it is less likely that an arbitration clause will be enforced. Under these circumstances, parties should consider whether other alternatives are available, such as commencing an adversary proceeding in the bankruptcy court to enforce claims.

Key English law considerations – overview

Under English law, the Insolvency Act 1986 is, of course, the primary legislation governing insolvency procedures, and the Corporate Insolvency and Governance Act (CIG), which entered into force on 26 June, makes certain amendments to the existing legislation.

Where a company enters members' voluntary liquidation or creditors' voluntary liquidation, there is no automatic moratorium on proceedings, whether litigation or arbitration, against the company (see the 2000 decision *A Straume Ltd v Bradlor Developments Ltd* for more on this). The court may – on application of a party such as a liquidator, creditor or shareholder – exercise its discretionary power to order a stay in relation to particular proceedings under section 112 of the Insolvency Act.

But when a company has entered into administration, filed an application to court for the appointment of an administrator, or filed a notice of intention to appoint an administrator, the company benefits from a moratorium: under Schedule B1, paragraph 43(6) of the Act, no legal process may be continued against the company or the property of the company, except with the consent of the court or the administrator where one has been appointed. Similarly, when a party to arbitration proceedings is subject to a winding-up order or a provisional liquidator has been appointed, the solvent party to the arbitration proceedings will have to apply to the court using section 130(2) of the Insolvency Act to seek permission to continue the proceedings.

In deciding whether to grant leave to commence or continue proceedings against a company in administration, the English courts will consider *inter alia* the balance of interests of the person seeking leave, against the interests of all other creditors in all the circumstances; the financial position of the company; any restructuring proposal; and the conduct of the parties (see *In re Atlantic Computer Systems* to see this in action).

The CIG introduces a number of measures that may become relevant in the context of any actual or potential arbitration proceedings against an insolvent party. In particular, the legislation provides for a stand-alone moratorium procedure, available to all companies (with some exceptions, including banks

and insurance companies) that can meet certain eligibility criteria and qualifying conditions. This moratorium applies for an initial period of 20 business days, but the period is extendable with permission of the court for up to a year – provided creditors owed more than 50% by value of the amounts subject to a payment holiday during the moratorium have consented. The moratorium provides that no legal process, including legal proceedings, execution, distress or diligence, may be instituted, carried out or continued against the company or its property, except for certain limited exceptions, including where the court has consented to the proceedings.

No uniform solution

The Insolvency Act 1986, as amended pursuant to the CIG, contains a number of measures that could clearly impact any ongoing arbitration with a seat in England and Wales, to the extent one of the parties to the arbitration enters into an English law insolvency process. However, the *Vivendi/Elektrim* case highlights an important point: there is no standard approach that can be applied internationally given the differing scope of insolvency processes in various jurisdictions.

The different approaches in the US and England and Wales to the potential impact of certain insolvency proceedings on arbitration underline that there is no uniform solution as to whether arbitration proceedings should proceed. It will depend on a number of factors: the stage of the insolvency proceedings, the jurisdiction in which they have been initiated, the seat of the arbitration, and the jurisdiction of the insolvent party's assets. The award creditor will have to consider the possibility of enforcing the award and likely recoveries, the availability of assets, and the ability of the award creditor to reach those assets.

In the situation where the respondent is subject to financial struggles or might enter an insolvency process, it might nonetheless be beneficial to press ahead with the arbitration proceedings. The arbitral award will determine any dispute as to the existence or quantum of the sum due, to be relied on for the purposes of filing any creditor claim as part of the bankruptcy proceedings.

If the company is entering liquidation or any insolvency procedures entailing a stay of the arbitration proceedings, the solvent party might consider reaching a commercial agreement over the sums in dispute. This may inevitably result in a compromise in terms of the amount of any settlement. However, considering the difficulty and uncertainty of enforcing any future award against an insolvent party and the time and cost likely required to obtain any recovery, a compromise might well yield a more positive outcome.

In the event the claimant decides to continue the arbitration proceedings rather than settle in the face of impending bankruptcy, the claimant should check if there has been any change in the status of a respondent that would prevent it

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from continuing with the arbitration proceedings: Do any applicable laws permit the respondent to continue to participate in arbitral proceedings? If the respondent's counsel takes the position that the arbitration must be stayed, the claimant should seek documentation of this position. The claimant should also confirm the respondent can continue with the arbitration proceedings and would be advised to request the production of relevant court orders, directions and powers of attorney to clarify such issues. A final procedural consideration for the claimant, if the insolvency proceedings are subsequent to the tribunal being appointed, is to check whether there might be any supervening conflicts of interest between the arbitrators and the appointed administrators. Were there to be some pre-existing commercial, professional or family connections with one of the arbitrators, this may disqualify an arbitrator from further involvement in the proceedings.

Moreover, the claimant should ascertain critical information as soon as the potential insolvency of the respondent is suspected. Where are the respondent's assets located, and can the respondent's assets within each jurisdiction be identified? If assets are located in different jurisdictions, retain local counsel and understand the implications of local insolvency laws. Determine what entity holds the relevant assets – for instance, the respondent itself or a third party on behalf of the respondent. Does any other party have a proprietary interest in those assets? Do third parties owe the respondent money, for example, an actionable letter of credit issued by a bank in a different jurisdiction?

Furthermore, some arbitration rules enable arbitral tribunals to order that a respondent provide security for all or part of the amount in dispute, including Article 25.1(a) of the LCIA Rules, Section 38 of the Arbitration Act 1996, Article 28(1) of the ICC Rules and Article 26 of the UNCITRAL Rules. A claimant should consider the advantages to obtaining such security. Under the English Arbitration Act of 1996, a counterclaimant is also a claimant for these purposes.

Case law has also established that if the parties have claims against each other, so that it was mere chance which party commenced proceedings first, security may be demanded from either or both of them (see *Cohl (Samuel J) Co v Eastern Mediterranean Maritime Ltd, Hitachi Shipbuilding & Engineering Co Ltd v Viafiel Campania Naviera SA* and *Petromin SA v Secnav Marine Ltd*). However, in the cases of insolvency, a tribunal may well refuse to order security in relation to potential damages as this is likely to violate the principle that all creditors in insolvency proceedings have the right to be paid on an equal footing, save for the existence of preferences.

There may be additional interim and enforcement measures available depending on the seat of the arbitration and the supportive powers of the courts in that jurisdiction. For example, the English courts have been using third-party debt orders to enforce awards against amounts owed by a third party to the

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respondent. To be eligible for such an order, the claimant would have to ascertain that the third party and the debt are within the jurisdiction and that the property belongs exclusively to the respondent. In *Taurus v State Oil Marketing Company of the Ministry of Oil, Republic of Iraq (SOMO)*) the UK Supreme Court significantly expanded the scope of possible third-party debt orders to include funds due under letters of credit issued by a bank located in England.

Conclusion

The insolvency of a party does not in itself affect the enforceability of an arbitration agreement, but could well lead to delays in the conduct of any proceedings. Depending on the circumstances, arbitration may still be permitted or compelled by a court. A supervening insolvency of a respondent may, in certain jurisdictions, restrict a claimant from continuing to pursue existing arbitral proceedings and may oblige an arbitral tribunal to stay the arbitration. It is important to consider the applicable regime in each jurisdiction. Further, the insolvency of an award debtor will constitute a serious practical obstacle to the enforcement of any monetary arbitral award. The challenges presented by parallel arbitration and insolvency proceedings will require counsel versed in these complex cross-border issues.

Further reading

Swiss Federal Tribunal, 31 March 2009, Vivendi v 4A, 428/2008

English Court of Appeal, 9 July 2009, *Syska & Anor v Vivendi Universal SA & Ors*, [2009] EWCA Civ 677

Warsaw Regional Court, 20 August 2009, file ref No VII Co 388/08, 16 November 2009 decision, file ref No I ACz 1883/09 and 18 November 2009 decision, file ref No I ACz 1686/09

Act of May 2015 – the Restructuring Law (amending the Polish Bankruptcy Law).

MF Global Holdings Ltd. et al. v. Allied World Assurance Co. Ltd. et al., No. 1:16-ap-01251 (Bankr. S.D.N.Y. 24 Aug. 2017);

In re MF Global Holdings Ltd. et al., No. 1:11-bk-15059 (Bankr. S.D.N.Y. filed 31 Oct. 2011).

See A Straume Ltd v Bradlor Developments Ltd [2000] BCC 333 ChD.

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In re OGX Petroleo E Gas SA (Nordic Trustee ASA and another v OGX Petroleo e Gas SA (Em Recuperacao Judicial) and another [2016] EWHC 25 (Ch)) (setting out the purpose and scope of the automatic stay of arbitration proceedings).

In re Atlantic Computer Systems [1992] 1 All ER 476, 501-2.

Corporate Insolvency and Governance Act 2019-2021, available at https://services.parliament.uk/bills/2019-21/corporateinsolvencyandgovernance.html

Cohl (Samuel J) Co v Eastern Mediterranean Maritime Ltd, The Silver Fir [1980] 1 Lloyd's Rep 371

Hitachi Shipbuilding & Engineering Co Ltd v Viafiel Campania Naviera SA [1981] 2 Lloyd's Rep 498

Petromin SA v Secnav Marine Ltd [1995] 1 Lloyd's Rep 603)
Taurus v State Oil Marketing Company of the Ministry of Oil, Republic of Iraq (SOMO) [2017] UKSC 64

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