International Secured Transactions & Insolvency Committee Newsletter

Volume 1, Issue 2 November 2013

Dear Committee Members

We hope you enjoy this issue of the International Secured Transactions & Insolvency Committee Newsletter; we welcome your feedback and encourage your involvement in this important quarterly Committee publication. The Committee leadership values your participation.

A special note of thanks to our contributors, Victoria Ferguson of Jones Day's London office and David Griffiths of Weil, Gotshal & Manges LLP's New York office. If you would like to contribute to the next quarterly issue of the newsletter, or, alternatively, have a question or suggestion, please contact Vice-Chair and Newsletter Editor Kevin P. Ray (raykp@gtlaw.com). The next issue of the newsletter is planned for January 2014.

In This Issue

- ***Sharia Compliant DIP Financing,*** *by David Griffiths*
- ***A Tale of Two COMIs: Kemsley v Barclays Bank plc****, by Victoria Ferguson*

International Secured Transactions & Insolvency Committee

Co-Chairs:
David L. Barrack
Robin Eric Phelan
Richard Walsh

Vice-Chairs:
Patrick L Del Duca
Philip Hoser
Daniel Marin Moreno
Kevin P. Ray
Charles D. Schmerler

Newsletter Editor-in-Chief:
Kevin P. Ray

Volume 1, Issue 2 November 2013

SHARIA COMPLIANT DIP FINANCING: COMING SOON, TO A BANKRUPTCY COURT NEAR YOU

By David Griffiths

The global market for Islamic finance has been growing at exponential rates, with the overall size of the Islamic financial industry increasing from approximately $80 billion in 2000 to approximately $1.3 trillion at the end of 2011. It's therefore not surprising that the United States Bankruptcy Court for the Southern District of New York recently approved a first-of-a-kind Sharia-compliant debtor-in-possession (DIP) financing and exit financing package in Arcapita Bank's bankruptcy cases. Sharia is the moral code and religious law of Islam.

Arcapita is a privately owned Sharia-compliant investment company, which holds minority ownership interests in a global portfolio of operating companies and other portfolio assets. The global economic downturn, and in particular the Eurozone debt crisis, severely limited Arcapita's ability to refinance a $1.1 billion syndicated facility that was set to mature on March 28, 2012. Despite having widespread support for an out-of-court restructuring from its existing lender group, Arcapita was unable to obtain the 100% lender consent required to restructure its syndicated facility, partly due to minority holdout lenders who sought to be bought out at par before they would agree to any modification of Arcapita's existing syndicated facility. Arcapita filed for chapter 11 protection on March 19, 2012.

A "Murabaha," typically consists of a sale by the "lender" of a specific amount of commodities for a set price (which consists of the actual out of pocket costs of the "lender" plus an agreed upon profit) to the "borrower." The "borrower" agrees to pay for the commodities on deferred payment terms. The "borrower" then sells the commodities, for cash, to a third party. The end result is that the "borrower" receives an immediate cash infusion and incurs a future obligation to pay the "lender" the agreed upon price.

The case is significant in that it involved the first approval of a Sharia-compliant DIP financing and exit financing package by a U.S. bankruptcy court. The key principles of Sharia relevant to Islamic finance as currently practiced in the United States include prohibitions on:

- transactions that are based solely on chance or excessive speculation, rather than on productive economic activity that generates a return;
- uncertainty, in contracts (thus requiring all of the fundamental terms of a contract to be ascertained at the outset);
- unjust enrichment, most commonly described as the prohibition of the payment or receipt of interest;
- transactions with an unethical purpose; and
- the unfair exploitation of one party by another.

As described in the motion to approve the DIP financing, one form of Sharia compliant

financing, a "Murabaha," typically consists of a sale by the "lender" of a specific amount of commodities for a set price (which consists of the actual out of pocket costs of the "lender" plus an agreed upon profit) to the "borrower." The "borrower" agrees to pay for the commodities on deferred payment terms. The "borrower" then sells the commodities, for cash, to a third party. The end result is that the "borrower" receives an immediate cash infusion and incurs a future obligation to pay the "lender" the agreed upon price.

Key principles of Sharia relevant to Islamic finance include prohibitions on:

- *transactions that are based solely on chance or excessive speculation, rather than on productive economic activity that generates a return;*
- *uncertainty, in contracts (thus requiring all of the fundamental terms of a contract to be ascertained at the outset);*
- *unjust enrichment, most commonly described as the prohibition of the payment or receipt of interest;*
- *transactions with an unethical purpose; and*
- *the unfair exploitation of one party by another.*

Arcapita commenced its chapter 11 cases with approximately $120.1 million in available cash, a significant portion of which went to fund existing deals in which Arcapita was invested to preserve the going concern value of Arcapita's assets and investments in its portfolio companies. Arcapita required additional funds to complete its restructuring, and thus sought $150 million of Sharia-compliant DIP financing. Arcapita and Silver Point, a Greenwich, Connecticut-based hedge fund that specializes in investing in distressed companies, initially negotiated a commitment letter for Silver Point to provide the Murabaha financing, however following extensive negotiations between parties-in-interest, Arcapita eventually selected a Murabaha financing package to be provided by Fortress Credit Corp., an investment management firm based in New York City.

The Silver Point DIP was initially structured as an initial $125 million multi-draw term facility that could be increased by an additional $25 million, of which $25 million was sought on an interim basis, with the remainder being subject to the entry of a final order by the Bankruptcy Court. The subsequent DIP package negotiated with Fortress provided for a $150 million Murabaha DIP facility comprised of an initial $100 million multi-draw term facility and a $50 million delayed draw term facility, which was conditioned on additional due diligence to be performed by Fortress. Outstanding obligations under the Murabaha DIP facility accrued profit at a rate equal to 1-month LIBOR plus a 10% margin per annum on the unpaid principal amount of the facility. The facility also included a 3% upfront fee (reduced by a $2 million commitment fee).

The DIP motion and order were relatively standard in terms of form and substance, though the approval order for each of the financings included specific findings with regard to the commodities transactions underlying the Murabaha financing (i.e., the sale of London Metal Exchange metals and

other Sharia compliant commodities that may be specified by Arcapita). These findings included that the purchases and sales of commodities through purchase contracts give rise to an extension of credit by the existing secured parties in the form of DIP obligations; are essential to the DIP facility and thus provide a basis for the Debtors to access the liquidity required to operate their businesses and preserve and enhance their enterprise value for the benefit of their stakeholders; and are necessary for the Debtors' overall restructuring. The commodities transactions are also specifically authorized on an interim basis by the Bankruptcy Court under section 363(m) of the Bankruptcy Code, and on a final basis under section 363(b)(1) of the Bankruptcy Code

Like the DIP Motion and order, the term sheets setting forth the DIP and exit financing proposals also were themselves fairly standard, and the Sharia aspect of the financing is apparent only in the description of the "Murabaha Transactions" provided in the Murabaha DIP Facility Term Sheet, which, as described above, involve the sale by an investment agent of commodities specified by Arcapita pursuant to purchase contracts, following which Arcapita will pay a deferred sale price for the commodities. The commodities themselves are simply London Metal Exchange metals and other Sharia compliant commodities that may be specified by Arcapita.

While the DIP financing and exit financing proposals were contested by some parties-in-interest who questioned whether the Murabaha financing was indeed Sharia compliant, rather than an (impermissible) organized *tawarruq* (monetization), Judge Lane ultimately agreed with the Debtors' position, supported by their Official Committee of Unsecured Creditors, that the compliance of the DIP financing with Sharia law is not – and cannot be – before the Bankruptcy Court, and that the standards for approval of DIP financing are set forth solely in the United States Bankruptcy Code, which does not mention Sharia compliance as a prerequisite for approval of a debtor's request for financing.

Ultimately, Arcapita borrowed $150 million under the original DIP facility from Fortress, and repaid approximately $40 million of those borrowings with proceeds from asset sales. With the original DIP facility scheduled to mature prior to the anticipated effective date of Arcapita's plan of reorganization, Arcapita and Goldman Sachs negotiated a replacement $150 million Murabaha DIP facility and up to $350 million in exit financing. The replacement Murabaha DIP facility has a profit rate of 8.0% per annum in cash plus 1.75% payable in kind (almost identical to the original DIP facility), subject to a 1.5% LIBOR floor.

As long as the proposed form of DIP financing is permissible under the Bankruptcy Code, a bankruptcy court may approve a Sharia-compliant financing structure. The ease with which the U.S. bankruptcy system is able to adapt to alternate forms of financing is a testament to its design and inherent flexibility. Other Islamic institutions and businesses in distress with a U.S. nexus may in the future consider U.S. bankruptcy courts as appropriate forums for restructuring, should (*Naudhubillah*) they need it. *Masaa Al Khair!*

*****

CHI 63913805v1

A TALE OF TWO COMIS: KEMSLEY V BARCLAYS BANK PLC

By Victoria Ferguson

The world is getting smaller. The number of people who hop from country to country through their lives is increasing. Inevitably, when a jet-setting life becomes financially troubled, bankruptcy and other court proceedings are likely to be similarly international. Two cases involving the same parties were heard in both the High Court in London and the US Bankruptcy Court for the Southern District of New York[1]. The judges were aware of the parallel cases, but each decided the questions before him on their own merits without reference to the judgment of the other court.

The UK ruling reflects the English High Court's unwillingness to interfere in the affairs of another jurisdiction without exceptional cause (with some discussion of what those causes might be). The US decision represents a ruling by a US bankruptcy court examining the relevant time frame for establishing "center of main interests" and "establishment" for the purposes of granting recognition of a foreign bankruptcy proceeding under chapter 15 of the US Bankruptcy Code.

These cases (and the complementary judgments) have relevance beyond the narrow confines of one individual's bankruptcy because they revolve around the US/UK trading axis. The UK ruling reflects the English High Court's unwillingness to interfere in the affairs of another jurisdiction without exceptional cause (with some discussion of what those causes might be). The US decision represents yet another ruling by a US bankruptcy court examining the relevant time frame for establishing "center of main interests" ("COMI") and "establishment" for the purposes of granting recognition of a foreign bankruptcy proceeding under chapter 15 of the US Bankruptcy Code.

It was the best of times…

Paul Kemsley ("K") was a British high-net-worth individual whose businesses in England had collapsed in 2009. One of his creditors was Barclays Bank PLC ("Barclays Bank") which had given K an unsecured loan. After the businesses failed, K and his family moved first to Florida and then New York City. In 2012 the couple became estranged and in June his wife and family returned to the UK while K remained in the US. K was declared bankrupt by his own petition in the UK in March 2012. The English court determined that K's COMI (under the EC Insolvency Regulation[2]) was in the UK because K was physically present in England at the time of the bankruptcy petition and because he resided there within three years of the presentation of the

[1] Kemsley v Barclays Bank Plc & Ors [2013] EWHC 1274 (Ch) (15 May 2013), 2013 WL 1904308 and In re Kemsley, 489 B.R. 346 (Bankr. S.D.N.Y. 2013)

[2] Council regulation (EC) No 1346/2000 of 29 May 2000

CHI 63913805v1

petition. K was discharged from his bankruptcy one year after filing, in March 2013, and all debts, including the loan from Barclays, were also discharged.

It was the worst of times…

Just before K was declared bankrupt in the UK, Barclays commenced proceedings under the loan agreement in the Supreme Court of the State of New York. Barclays also commenced proceedings in Florida over a property K owned there. In August 2012, K's English Trustee in Bankruptcy ("TiB") filed a petition in the US Bankruptcy Court for the Southern District of New York, seeking recognition of K's English bankruptcy as a foreign main proceeding under chapter 15 of the US Bankruptcy Code. The New York state-court litigation was stayed pending the bankruptcy court's ruling on the chapter 15 petition.

During this chapter 15 "gap" period K and his TiB sought an anti-suit injunction from the High Court in London preventing Barclays from pursuing collection proceedings in the US. The injunction application was based on two grounds:

(i) Barclays would obtain an unfair advantage for itself over other creditors by recovering K's assets in the US; and
(ii) K would not be released from his English bankruptcy debts on his discharge from bankruptcy (due to occur in late March 2013) as any judgment of the New York court would be enforceable for 20 years in the US and any other jurisdiction which recognised the judgment.

The English High Court's Ruling

The court refused to grant the anti-suit injunction. It explained that K's COMI could only be in either England or the US. The court noted that if the US bankruptcy court determined that K's COMI was in England, the English bankruptcy would be recognised as a foreign main proceeding under chapter 15 and any other litigation would be stayed. If COMI were found to be in the US, the court concluded, it would not be appropriate for an English court to intervene in a foreign proceeding. Barclays could proceed in the US as it saw fit and K would be entitled to challenge any such actions in the relevant US courts. The High Court further explained that if the US bankruptcy court recognised K's English bankruptcy as a foreign non-main proceeding because K had merely an "establishment" in the UK (as distinguished from COMI) the TiB, as K's foreign representative, could also seek an injunction of all pending US litigation against K or his assets.

The High Court explained, an injunction should only be granted if it would be oppressive or unfair not to do so. The court felt that this was not the case here, especially as Barclays had been very open with the TiB about its plans and had, notably, undertaken to pass over to the TiB any recoveries it realised in the US, so that its actions would benefit all creditors.

Added to this, the High Court explained, such an injunction should only be granted if it would be oppressive or unfair not to do so.

The court felt that this was not the case here, especially as Barclays had been very open with the TiB about its plans and had, notably, undertaken to pass over to the TiB any recoveries it realised in the US, so that its actions would benefit all creditors.

The US Bankruptcy Court's COMI finding

Shortly after the anti-suit injunction decision was made, the US bankruptcy court refused to recognise K's English bankruptcy as a foreign main or non-main proceeding under chapter 15. The court held that K's COMI needed to be adjudged as at the time of his English bankruptcy petition, not the time of the chapter 15 filing. Rejecting K's statement at the time of his English bankruptcy petition, the court found that his COMI was the US at that time; focusing on K's habitual place of residence and that of his family.

The court then considered whether K had an establishment in the UK. It found there was insufficient connection; for example, there was no contract of employment, no regular schedule of visits or work and no evidence that an office in London was used for "non-transitory economic activity". That being the case, the US bankruptcy court concluded that K's English bankruptcy case did not qualify as foreign proceedings (either main or non-main) under chapter 15. Coupled with the High Court's rejection of the English anti-suit injunction, Barclays would be free to proceed with the state-court litigation in New York and Florida, with any realisations to be turned over to K's TiB for the benefit of all creditors.

As a side note, just as Barclays' conduct (i.e. agreeing to turn over recoveries for the benefit of all creditors) seems to have been considered by the English court, so K's behaviour was examined by the US bankruptcy court. The bankruptcy court noted that K's bankruptcy had not "diminished his high standard of living" primarily through the support of "generous friends". The court was also concerned that there might be a "co-ordinated trans-Atlantic litigation strategy … to shield [K's] assets from enforcement action by Barclays" thus achieving " a result that [was] adverse to the interests of one of [K's] major creditors". Foreign representatives seeking recognition under chapter 15 as a means of protecting US assets should be aware that the US bankruptcy court may look at more than just the immediate petition for chapter 15 relief. As is frequently the case, honesty and transparency of motive is likely to increase the receptiveness of the court to one's arguments.

Contributors to this Issue:

Victoria Ferguson is a solicitor in Jones Day's London office, focusing on noncontentious insolvency matters and corporate restructuring. This article first appeared in Jones Day's Business Restructuring Review.

David Griffiths is a senior associate in the business finance and restructuring department of Weil's New York office. This article was first published on Weil's Bankruptcy Blog at http://business-finance-restructuring.weil.com/

About the International Secured Transactions & Insolvency Committee

This committee focuses on issues relating to international and comparative bankruptcy and insolvency law and practice, including efforts to develop greater international harmonization of laws, regional and national approaches to bankruptcy and insolvency issues; and developments in countries or regions that are implementing or changing their bankruptcy and insolvency laws.

Join the International Secured Transactions & Insolvency Committee!
Members of the Section of International Law may join as many committees as they want, including the International Secured Transactions & Insolvency Committee.

Visit http://www.abanet.org/intlaw/committees/join.html to join the committee(s) of your choice.

Not a Member of the Section of International Law?
If you're not a member of the Section of International Law, visit https://www.abanet.org/members/join/ to join today.

CHI 63913805v1