Testing The Limits of Cross-Border Judicial Recognition:

The Case of Foreign Solvent Schemes of Arrangement

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Introduction

Canadian courts have long been willing to recognize and give assistance to foreign proceedings and judgments where various recognition criteria are met. These criteria have evolved and expanded over time, reflecting the expansion of global commerce and cross-border transactions. The primary focus of the current test for recognition is whether the foreign proceeding bears a real and substantial connection to the action[1]. The evolution of recognition criteria has in recent years included statutory jurisdiction to recognize certain foreign insolvency proceedings.[2]

The boundaries of recognition of foreign proceedings continue to be tested, however, as shown in the Ontario case of *Re Cavell Insurance Co*.[3] One U.K. commentator observed the trial level decision was "certainly commendable in its internationalist approach" and "chimes with the general global trend of facilitating cross-border restructuring".[4] The case raises, however, fundamental questions as to how far the boundaries of recognition should be stretched in the case of certain types of foreign proceedings, and as to the role of conditional recognition as a device in the recognition process.

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[1] See, e.g., *Beals v. Saldara* [2003] 3 S.C.R. 416.

[2] *Bankruptcy and Insolvency Act,* R.S.C. 1985 c. B-3, sections 267-275 and *Companies' Creditors Arrangement Act,* R.S.C. 1985, c. C-36, section 18.6.

[3] The trial level consideration of the *Re Cavell* case actually involved three decisions of Justice Farley in the Ontario Superior Court of Justice – Commercial List: the reasons issued on the initial recognition hearing, the reasons issued on a subsequent "come-back" motion, and reasons following a further hearing on the terms of the order made on the come-back hearing. These can be found respectively at *Cavell Insurance Co., Re*, 2004 Can LII (48709 (Ont. S.C.), or (2004) 6 C.B.R. (5th) 11; *Cavell Insurance Co. (Bankruptcy), Re*, 2005 Can LII 4094 (Ont. S.C.) ("*Cavell (No. 2)*"); and *Cavell Insurance Co., Re*, 2005 Can LII 14315 (Ont. S.C.) ("*Cavell (No. 3)*"). The Court of Appeal's decision was released May 23, 2006 (Docket C43657).

[4] Look Chan Ho, "A new byword for cross-border restructuring: Scheme of arrangement as judgment (*Re Cavell*)"; Lloyd's Maritime and Commercial Law Quarterly, Vol. 2005, Part 3, August 2005, 295-302, 297, 300-301.

Background

Cavell, a company based in London, England, is a "reinsurer". Its business is to issue insurance coverage (i.e., 'reinsurance') to insurance companies that in turn have issued policies to their policyholders. In the early 1990's, Cavell ceased to issue new policies and it entered into what is known as a "run-off" of its reinsurance business, administering its assets and dealing with its liabilities as they continue to develop under those policies issued while it was still underwriting. The run-off was estimated to take a few decades to run its course. Given the nature of the risks that Cavell covered, many claims were expected to be made, and/or to reach a state where they can be finalized, only many years after the policies were issued.

Cavell operated a Canadian branch under the provisions of the *Insurance Companies Act*,[5] and its predecessor legislation. Cavell's estimate of the value of its remaining known and unknown liabilities under its Canadian branch policies was, at the time of the hearing, approximately $6 million. Cavell had approximately $23 million of assets in Canada, most of which were vested in a trust pursuant to Canada's legislative and regulatory requirements in respect of foreign insurers that operate Canadian branches. Under the federal insurance regime, the trust assets are effectively held for the benefit of holders of policies issued by the Canadian branch, constituting *de facto* security for payment of the branch's potential liabilities in the event the foreign insurer becomes insolvent.

[5] S.C. 1991, c.47.

The Foreign Scheme of Arrangement

Schemes of arrangement under section 425 of the *Companies Act 1985* (U.K.) are an established mechanism for finalizing the affairs of insolvent companies to which the Act applies. Recently, however, many *solvent* U.K. insurance or reinsurance companies that are in run-off have resorted to schemes of arrangement as an exit strategy to terminate all their policy liabilities, to put an early end to the run-off, and to free up the remaining capital that would otherwise be held to back those liabilities.

In late 2004, Cavell announced it was putting forth a solvent scheme of arrangement. As is typical under solvent schemes, holders of Cavell reinsurance policies would be required to file for the value of not only all their known claims under those policies as at a fixed date, but all future and unknown claims. This necessarily requires an estimate of loss claims that will be incurred, possibly over many years. If a claimant and the scheme administrator cannot agree on the value of a claim, an adjudicator chosen by Cavell would make a final, binding estimate valuation, which would then be payable in accordance with the terms of the scheme. All rights of Cavell's policyholders to any other payment (including for any actual losses incurred in excess of the estimate) would be fully extinguished and the policies would be terminated.

Until Cavell's scheme, no solvent foreign insurer had sought to enforce such a scheme on policyholders of the insurer's Canadian branch.

The Foreign Proceedings and the Recognition Order

In accordance with the practice in the U.K. courts, Cavell first obtained an 'initial order' of the U.K. court authorizing the proposed meeting of scheme claimants and providing for notice of

scheme proceedings. Cavell then moved before the Commercial List in the Ontario Superior Court and was granted an order:

- recognizing the U.K. proceedings and the initial U.K. order;
- limiting claimants with claims against Cavell's Canadian assets to pursuing such claims in the U.K. scheme proceedings;
- permitting Cavell, upon approval by a requisite majority of Cavell's scheme creditors and the U.K. court at a sanction hearing, to apply to the Ontario court for scheme approval and such further orders as deemed necessary, including orders in respect of the claims process to be instituted under the scheme;
- staying all proceedings against Cavell or its Canadian assets, unless leave of the Ontario court is first obtained.

Several policyholders of Cavell's Canadian branch took issue with the Ontario recognition order, and moved under its comeback provision to have it set aside or varied. On the comeback hearing, the Ontario court (i) confirmed its jurisdiction to recognize and assist the U.K. scheme proceedings and (ii) confirmed that the scheme proceedings would in fact be recognized.

The trial court's decision was appealed to the Court of Appeal. The Court of Appeal rejected, and overturned, the statutory basis of the trial decision. At the same time, it upheld the recognition of the initial U.K. order on the basis of private international law, and significantly expanded the common-law parameters for recognition of foreign orders.

The facts of this case, and the expanding popularity of foreign solvent schemes, bring to the fore issues that likely will be subject to further debate in a judicial or legislative context (or both), as the boundaries of cross-border recognition continue to be explored.

Basis for the Recognition Order

No Canadian statute expressly confers jurisdiction to recognize or assist foreign *solvent* schemes of arrangement. *Re Cavell* held there was jurisdiction to do this, however.

(i) Statutory

At the trial level, jurisdiction was firstly found under Ontario's *Reciprocal Enforcement of Judgments (UK) Act*[6], which implements the Canada-U.K. *Convention Providing for the Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters* (the "*Convention*"). The trial court in *Re Cavell* rejected an argument that the U.K. initial order was not a "judgment" for the purposes of the recognition provisions of the *Convention.* Also, although the *Convention* provides that it does not apply to judgments that determine the winding-up of companies, the court held that the U.K. order did not fall within this exclusion, as a solvent scheme of arrangement was not a winding-up or akin to one. The court observed, however, that the *Convention* "is a difficult read and awkwardly presented."[7]

On appeal, the statutory basis for recognizing the U.K. order was squarely rejected, however. The Court of Appeal held that the U.K. order was not recognizable under the *Convention* because (i) the U.K. proceeding had not been served on the Canadian parties, and (ii) the U.K. order was not a "final order" within the meaning of the *Convention*.

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[6] R.S.O. 1990, c. R.6.

[7] *Re Cavell (No. 2)*, paras. 8-15.

(ii) Private International Law

The court in *Re Cavell* invoked a second, independent ground for recognizing the U.K. proceedings: the principle of comity, effected through the vehicle of inherent jurisdiction. The objecting Canadian policyholders argued that it was not an appropriate case to invoke the comity principle, since the process under the U.K.'s *Companies Act 1985* significantly diverged from the voluntary dissolution process that would apply under Canadian legislation, and since they would lose the unique benefit from having the Canadian security for potential losses that they may claim under their policies. The trial court rejected this position, citing its conclusion that the scheme was not a dissolution or winding-up, and the fact that Canadian insurance regulator would retain control over the release of the vested assets.[8]

The Court of Appeal not only upheld the recognition of the U.K. order on the basis of private international law, but went some distance to expand the boundaries of recognition on this basis. The Court of Appeal noted that although traditionally under Canadian law a foreign order must be final and *res judicata* in the foreign jurisdiction (i.e., the foreign court no longer has the power to rescind or vary it), those prerequisites should no longer apply. Rather, the focus should be on whether the *purpose* of those requirements has been met. The Court of Appeal defined the purpose of the traditional finality requirement to be as "at least" threefold: (i) to ensure the domestic court knows precisely what it is agreeing to recognize and enforce, (ii) to remove the risk of the injustice that would be done to the party against whom the foreign order is enforced if that order is subsequently changed by the foreign court, and (iii) to remove the risk of

[8] Interestingly, the *Convention* and comity might <u>not</u> be applied reciprocally by a U.K. court: Look Chan Ho, *supra*, 300.

undermining public confidence that might arise if the domestic court were to issue a recognition order, only to have the foundation of that order, namely the foreign order, disappear.

The Court of Appeal recognized that obviously the initial U.K. order did not in fact finally decide the substantive issue affecting Cavell and the Canadian policyholders because it did not approve the scheme of arrangement and it merely commenced the procedure which may lead to the U.K. court ultimately approving the scheme. However, because it found the U.K. order (i) to be "undoubtedly clear and certain", (ii) to present "little if any risk of injustice" to the Canadian policyholders, and (iii) to have "little risk of undermining public confidence if the procedure initiated by the U.K. order is changed following its recognition by the Ontario court", the purpose of the traditional finality requirement was met here. The Court of Appeal stated that:

> "… in an age where the rules of private international law are evolving to accommodate the increasingly transnational nature of commerce, I see no reason why this result should be precluded by those rules just because the foreign order to be recognized is not final. In my view the want of finality carries with it no substantive effect that should deny recognition."

The Court of Appeal also expressly held that there were "strong policy reasons" for giving recognition to the initial U.K. order. In particular, "the doctrine of comity is well served by an Ontario recognition order," as is "the related notion of reciprocity". With respect to the latter, the Court stated that each of the *Canada Business Corporations Act* and the *Business Corporations Act* (Ontario) has procedures for approving solvent schemes of arrangement, and:

> "If an Ontario court were administering such a scheme, and it affected interests in the United Kingdom, the court would hope for the same recognition of its orders as is sought in this case."[9]

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[9] But see note 4, *supra*

The Court of Appeal also held that, under private international law, the failure to serve the Canadian interests with the U.K. proceeding was irrelevant, as the Canadian interests had been accorded "a fair process".

Lastly, the Court of Appeal held that the "real and substantial connection test" was met in this case, as the subject matter was a scheme of arrangement proposed by a U.K. company under U.K. law and it would affect all the creditors of the company, only a small percentage of which are in Canada.

Conditions on Recognition

In an interesting aspect of *Re Cavell*, the trial court did not grant *carte blanche* recognition to the U.K. proceedings however. Rather, the court recognized the Canadian parties' "valid criticism" that under the scheme the adjudicator of claims would have absolute discretion with respect to making his determination, which would be final and binding and "absent any meaningful right of appeal". The court thus imposed express conditions on its recognition, including that (i) the scheme adjudicator must reach a valuation based on the Canadian rules applying to valuations, recognizing that Canada requires the trust assets to be held, (ii) there will be a right of judicial appeal if the scheme adjudicator fails to apply the Canadian rules, and (iii) the scheme administrator and the scheme adjudicator must act in good faith and treat the Canadian policyholders fairly.[10] These conditions were not changed by the Court of Appeal.

The court's use of conditions on recognition of the foreign order appears to be an attempt to "finesse" the effect of the foreign proceeding where it did not at its root offend the Canadian

[10] *Re Cavell* (No. 2), paras. 17-18 and *Re Cavell* (No. 3), paras 9-10.

court so as to justify outright refusal to grant recognition, but where some aspects of the foreign proceeding appeared to the court to require adjustment to protect legitimate Canadian concerns. It will be interesting to see whether this conditional technique is adopted by Canadian courts in future cases.

Testing the Limits – The 'Universalist" Approach and the Role of Public Policy

One of the grounds long recognized in the common law for refusing recognition of a foreign order (and codified in the *Convention*) is where enforcement of the judgment would be contrary to public policy in the jurisdiction of the domestic court. *Re Cavell* raises the interesting question of the impact that should be accorded Canadian public policy, especially that inherent in a regulatory regime for foreign companies that choose to do business in Canada.

The trial decision in *Re Cavell* forcefully espouses the view that the Canadian policyholders knowingly dealt with a U.K.-based entity, and therefore subjected themselves to the consequences of U.K. company law, including a solvent scheme of arrangement. Indeed, the court states that there is "much merit" in the proposition in American jurisprudence (known as the 'universalist' approach) that parties who deal with a foreign company impliedly subject themselves to the laws of the foreign government affecting the powers and obligations of the company, and "anything done at the legal home of the corporation, under the authority of such laws, which discharges it from liability there, discharges that everywhere."[11]

It must be noted that Anglo-Canadian law, however, in fact appears to be contrary to this proposition. Canadian courts favour a more contextualized approach when determining what

[11] *Re Cavell (No. 2)*, para. 14, citing, *Canada Southern Ry. Co. v. Gebhard*, 109 US 527.

law should govern international disputes.[12] In the context of a foreign bankruptcy, the Supreme Court of Canada squarely rejected the purely "universalist" approach suggested by the American jurisprudence that would necessarily have bankruptcy disputes settled by the law of the place of bankruptcy. [13] The Supreme Court of Canada has also held that in determining the proper law of an insurance contract, the location of the head office is only a *factor* to consider, and is not determinative of the law governing the contract.[14] The Court of Appeal decision does not appear to address this issue.

In the case of contracts entered into under a Canadian regulatory regime, such as the insurance regime, arguably there is an especially compelling case that foreign company law should not be applied to discharge obligations where that would defeat the implicit Canadian policy principles under which the foreign company voluntarily undertook to do business in Canada. The trial court in *Re Cavell* clearly took comfort from the fact that the Canadian insurance regulator still controlled the release of the foreign insurer's trust assets held in Canada. However, one may ask if an equally important public policy interest is that a Canadian branch's policyholder bargained for insurance coverage in accordance with its insurance policy, and not for a forced termination at an estimated value – even if payment of that estimated value is protected by the security. The estimated value may ultimately bear no relation to the indemnification that it would otherwise be entitled to for as yet unknown, but very real, losses. Even if a forced termination scheme were not itself contrary to Canadian public policy, arguably there should be financial recognition of the distinct economic benefit arising from the required

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[12] Cavell and Walker, *Canadian Conflict of Laws*, 6th ed., 31.2.

[13] *Holt Cargo Systems Inc. v. ABC Containerline N.V. (Trustees of)* [2001] 3 S.C.R. 907, 940-945.

[14] *Imperial Life Assurance Co. of Canada v. Colmenares*, [1967] S.C.R. 443, 449.

security (trust assets) for branch liabilities over and above the general creditworthiness of the insurer. A termination of rights that are backed by a special, legislated creditworthiness may be deserving of higher compensation in the valuation process than the termination of rights for which the sole recourse is to the general, less certain, creditworthiness of the insurer.

Another reality – and complication - arising from an expansive approach to recognition of unusual foreign proceedings is that the law in the foreign jurisdiction may itself evolve at a fundamental level. Shortly after the *Re Cavell* trial decision, the U.K. High Court of Justice, Chancery Division, Companies Court, rendered a judgment in the first opposed sanction hearing for a solvent scheme of arrangement in respect of an insurance company: *Re British Aviation Insurance Company Limited* ("*BAIC*").[15]

In *BAIC*, the U.K. court held that it was not necessary to rule on the fairness of the proposed scheme became the scheme's proponent had failed to meet the jurisdictional threshold when it incorrectly constituted the classes of creditors. Nonetheless, the court went on to hold that it would have refused to sanction the scheme in any event, given the unfair aspects of the scheme including the fact that creditors would no longer be indemnified but would only be paid an estimate of their liability. This criticism is to a large degree a criticism of the inherent aspect of any solvent scheme of arrangement for an insurance company, and goes to the fundamental principles underlying the appropriateness of such schemes. Domestic courts considering the question of granting recognition and assistance orders (or indeed the ultimate sanctioning of a

[15] [2005] EWHC 1621 (Ch).

foreign scheme) will need to carefully consider the role and impact of such considerations in their own analysis.[16]

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[16] Interestingly, the trial court in *Re Cavell (No.2),* para. 5 noted that the Canadian insurance regulator took the position in that case that the scheme matters were primarily a contractual matter between Cavell and its Canadian reinsureds. The position of a Canadian regulator in this or other areas may be influential for courts in future cases where the effects of a foreign proceeding potentially clash with Canadian public policy.