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Navigating offshore restructuring and insolvency complexity

The use of offshore structures has become increasingly common. What role does the 'offshore' jurisdiction play in practice when the jurisdiction of incorporation is separated from the assets, information and creditors by geographic and legal boundaries?

Use of 'offshore' vehicles

Offshore structures vary from single entities to complex group structures, sometimes involving more than one offshore jurisdiction. The common denominator is an offshore entity holding assets, either directly or indirectly, in another jurisdiction, typically onshore. Creditors, management and data are typically held onshore as well.

While the use of such vehicles for tax evasion, fraud, corruption and asset concealment is known – exploiting favourable corporate confidentiality/secrecy provisions, particularly if multiple jurisdictions are used – the frequency is outweighed by the extensive use of such structures for legitimate reasons.

These include specialist legislation and concentration of professionals dealing in particular industries, such as hedge funds or insurance, and tax simplification by rolling up gains in a low or no tax jurisdiction until they are paid to investors. Regulatory, collateral rights and capital flow restrictions in some onshore jurisdictions, which would otherwise handicap the realisation of investments or capital raising. A prime example is the common use of offshore structures to hold assets in China, with Caribbean offshore jurisdictions being amongst the largest external investors into China.

Regardless of the rationale, given the nature of the entities using offshore structures, it is not surprising that the corresponding challenges feature in some of the largest insolvencies and restructurings.

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Challenges associated with offshore insolvency and restructuring

Control of assets and proceedings in foreign jurisdictions

Other jurisdictions, even those that have adopted the UNCITRAL Model Law (see page 3), may not recognise the insolvency practitioner's authority. A similar issue applies to the enforcement of foreign judgments or orders. This is a particular problem with common law based offshore jurisdictions dealing with civil law jurisdictions, but issues with other common law jurisdictions are surprisingly frequent.

In the absence of cross-border recognition, obtaining assistance through alternate mechanisms such as the Hague Convention can be extremely time consuming, and is not guaranteed to succeed.

Investigation, tracing and recovery

Investigatory powers granted to an insolvency practitioner may not be recognised or legal in another jurisdiction. Even access to the company's own data or transactional documents may be restricted. The inclusion of jurisdictions with confidentiality laws exacerbates the problem. Offshore jurisdictions are typical examples, as is Switzerland – where providing an overseas practitioner with data held in Switzerland can constitute a criminal offence even when it's the company's own data.

Inconsistency in law across jurisdictions

Inconsistency in law, and the absence of a mechanism for recognising the primacy and application of a foreign jurisdiction's law, can lead to significant problems in harmonising treatment of creditors across jurisdictions, or in enforcing powers and remedies that may apply in one but not others. The flip-side can also be true, with the offshore jurisdiction offering the practitioner greater scope than the onshore.

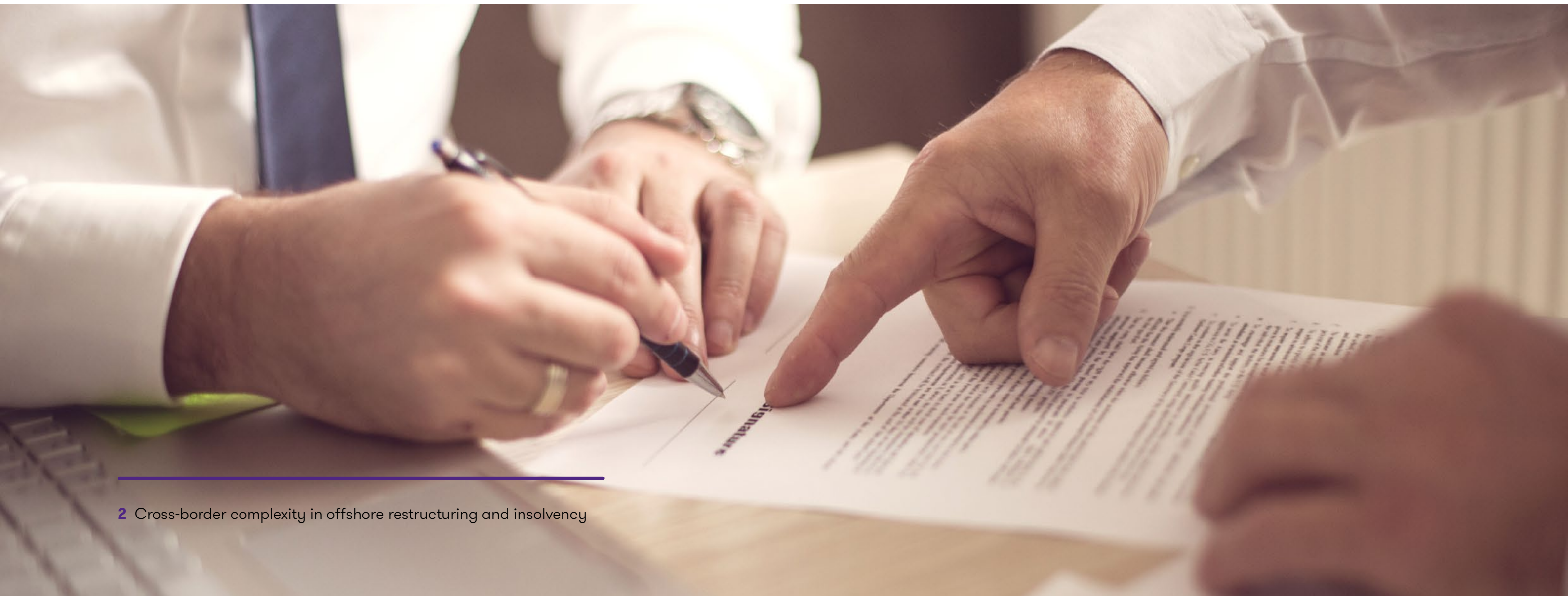
However, the opportunity to exploit legal arbitrage in common law jurisdictions has been curtailed by the Privy Council decision in the Saad Investments case, which focused on the Cayman liquidators' attempts to compel a Bermuda-based auditor to divulge records. The Privy Council found that a practitioner could not benefit under common law assistance from powers greater in the recognising jurisdiction than they would be able to apply in the primary jurisdiction.

Global consolidation

Where you have a multinational entity in distress, with critical functions split across different jurisdictions (increasingly common in a globalised world), any solution requires the problems in each jurisdiction to be addressed in parallel.

Providing equity in outcomes is helpful in reaching consensus, but can be extremely difficult in the absence of common principles in the treatment of creditors and the ability to bind consensus.

The immediate issue is typically the difficulty in imposing a moratorium against creditor actions – intended to ensure equity – making it extremely hard to ensure an equitable outcome across jurisdictions.



Limitations of legislative solutions

Twenty years ago, the [UNCITRAL Working group] issued the Model Law, designed to address these problems. The concept was that states would have a consistent approach – based on the Model Law – to identifying the 'main proceeding' based on the principle of the Centre of Main Interest (COMI). They would recognise the foreign practitioner's authority and cooperate in facilitating a process based on the main jurisdiction's legislation.

A number of jurisdictions have adopted the Model Law, either directly or by following its precepts – such as the European Union (EU) and the US. However, uptake has not been universal.

Even where adopted there have been practical problems in its application. Determining COMI has been a major issue, given the Model Law's approach of providing guidelines rather than discrete and determinative criteria. This has been of little practical use when faced with issues like: the hedge fund industry, where entities are virtual vehicles with no employees or physical place of business and assets and creditors can be spread across the globe, or globalised businesses which may have different aspects of the business – all critical – located in different jurisdictions to gain tax advantages or because of local economic advantages or cost efficiencies.

The practical problem in identifying a single COMI in such cases has been compounded by jurisdictional self-interest, coupled with genuine confusion over the application of what were meant to be Universalist principles.

For example, obtaining main proceeding recognition from the US courts for offshore incorporated hedge funds was a major problem before the landmark [Fairfield Sentry case.]

However, that decision relied on the critical determination that the COMI test should be based on the relevant facts at the time of application for recognition (at which point Fairfield was under control of the offshore liquidators), not the commencement of the main proceeding. The latest guidance from UNCITRAL indicates that the commencement date should be determinative. If this is taken up by the US courts, offshore hedge funds will once again face difficulties in obtaining recognition in the critical US jurisdiction.

Another example is that of Australia – where the Saad Investments case was the first application for recognition under a Model Law-based recognition system. Despite recognising the Cayman-based liquidation as the main proceeding, the highest court in Australia upheld the court of first instance and appeal court ruling that the liquidators' ability to intromit with the Australian assets was subject to protecting the claims of the Australian tax authorities, in effect providing them with a first call on the Australian assets.

While the European Union Regulation on Insolvency Proceedings introduced in 2000 attempted to implement UNCITRAL principles, despite numerous amendments, arguments remain over the identification of COMI and the recognition of cross border authority.

In 2016, the EU commenced a project intended to address this by harmonising insolvency law. The complexities of obtaining consensus on that will be considerable, quite apart from the forthcoming exit of the UK from the EU.

Of course, none of the above assists where countries have not adopted the Model Law. Even the so-called Universalism movement in common law jurisdictions, assuming the judiciary would use common law authority and discretion to attempt to achieve comity in the absence of statutory provision, have proved less than successful, as demonstrated by the Rubin and Eurofoods cases.

The reality is that the problems of cross border structures are not only material, but are also likely to persist for some time.

How can I choose the right approach for my business?

Professionals dealing with cases where cross border work is inevitable must consider the practical alternatives in dealing with jurisdictions that have no recognition mechanisms, or where that recognition is impaired or constrained.

Parallel proceedings

Parallel proceedings have the issue of duplication of cost as well as the potential for difficulties in co-ordinating approaches between appointees. There is the risk of the proceedings being subject to conflicting directions by the differing regulatory or court authorities, and conflicting law that may mandate different treatment of creditor classes.

However, they do resolve the issue of local authority, and duplicative costs may be limited, particularly if using a single firm of professionals with offices in all jurisdictions. The firm's internal procedures can help address the co-ordination and consistency of approach issues. Risks related to the contrasting law depend entirely on the jurisdiction, and it is surprising how many elements can be consistent between jurisdictions, especially if they are all common law based. Even if there is a conflict in treatment, issues of prejudice are limited, provided the creditors in that jurisdiction do not end up with a result any worse than they would have endured in a stand-alone domestic insolvency or restructuring.

Finally, the parallel proceeding may offer additional forms of authority and relief not available in the domestic one. In the Saad Bermuda case, for example, while the Cayman liquidators were denied access to Bermudan statutory powers under common law principles, there was no contention that they would have been able to access the statutory powers with a parallel proceeding had there not been a procedural problem with their parallel appointment.

Use of non-judicial authority

The creative practitioner should consider methods and authority that can be employed in a third-party jurisdiction without relying on statutory authority in that jurisdiction, or reliance on cross border recognition of his domestic authority. This could be as simple as using their authority over the domestic entity to instruct the repatriation of assets or data to the domestic jurisdiction, whether directly or through management. In offshore holding company structures, practitioners are used to indirectly asserting authority over subsidiaries by exercising their power qua shareholder rather than powers directly granted by the court – indeed, in some jurisdictions such as the People's Republic of China it would be a criminal offence to do the latter whereas the former is perfectly permissible.

The right approach

The use of parallel proceedings or non-judicial authority may not be a solution in every case. However, given the obvious difficulties with reliance on cross border recognition or foreign courts commitment to comity, a creative approach is critical. A careful assessment of the distribution of assets and the potential risks of the various options is required. Practitioners need to be open to the alternatives available, the best choices may well involve a mixed range of approaches, tailored to the specific jurisdictions involved.

Practitioners with an international network that spans jurisdictions and facilitates joint appointments and local representation have a significant advantage in finding and delivering the optimal approach. It mitigates the control and co-ordination issues, facilitates local management of critical vendor and court relationships, and allows a rapid response.

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