ARTICLES

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Fairfield Sentry and the limits of comity in Chapter 15 cases

Introduction

In the cross-border insolvency case of Fairfield Sentry Limited, the United States Court of Appeals for the Second Circuit held that U. S. bankruptcy law governed the sale of intangible property of a foreign debtor, Fairfield Sentry Ltd. ("Fairfield"), which was in liquidation proceedings in the British Virgin Islands ("BVI"). The BVI court overseeing the liquidation had approved the sale of the intangible asset under BVI law. When the sale was brought before the U. S. bankruptcy court overseeing Fairfield's ancillary cross-border case under Chapter 15 of the United States Bankruptcy Code, the bankruptcy court declined to review the merits of the proposed sale under U. S. bankruptcy law and deferred instead to the BVI court's approval of the sale, under the doctrine of international comity. On appeal, the Second Circuit rejected the bankruptcy court's ruling, noting that international comity cannot override the Bankruptcy Code's plain language. The Second Circuit instructed the bankruptcy court on remand to evaluate the merits of the sale under U. S. bankruptcy law. On January 13, 2015, the Second Circuit denied the losing party's motion for rehearing and thus cemented its ruling.

Over a century ago the United States Supreme Court described the doctrine of international comity as the "recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens, or of person who are under the protection of its laws." Chapter 15 of the Bankruptcy Code – which incorporates the Model Law on Cross-Border Insolvency ("Model Law") promulgated in 1997 by the United Nations Commission on International Trade Law – adopts a "pro-comity approach" to transnational insolvency cases. Chapter 15, among other things, provides for recognition of foreign insolvency proceedings and "for ancillary relief in a broader structure that mandates cooperation with foreign courts and foreign representatives and coordination of multiple proceedings involving a common debtor." Courts have characterized the doctrine of international comity as "central" to or a "principal objective" of Chapter 15 of the Bankruptcy Code. Yet, in Fairfield Sentry, the Second Circuit ruled that deference to a foreign tribunal in accordance with international comity cannot override the plain language of the Bankruptcy Code when that language leaves no room for deference or discretion by the bankruptcy courts. Fairfield Sentry thus joins an emerging line of court decisions holding

1 This article was first published in the Insolvency & Restructuring Newsletter of the International Law Office – www.internationallawoffice.com.

that the doctrine of international comity is not without limits in Chapter 15 cases.

Background

Fairfield was a BVI "feeder fund" that invested approximately 95% of its assets with Bernard L. Madoff Investment Securities, LLC ("BLMIS"), a firm wholly owned by Bernard Madoff. Shortly after Madoff's massive Ponzi scheme was unmasked in 2008, BLMIS collapsed and entered liquidation proceedings before the U. S. Bankruptcy Court for the Southern District of New York under the U. S. Securities Investor Protection Act. A trustee was appointed to administer the liquidation of BLMIS. Having suffered net losses approaching $1 billion, Fairfield filed three customer claims in the BLMIS liquidation, which the trustee disputed. The dispute eventually was resolved, with Fairfield receiving an allowed claim of $230 million ("SIPA Claim").

Facing financial distress of its own, Fairfield was placed into liquidation before the BVI court. The BVI court appointed a liquidator, who, in turn, petitioned the U. S. Bankruptcy Court for the Southern District of New York to recognize the BVI liquidation under Chapter 15 of the Bankruptcy Code. The bankruptcy court granted the petition, and recognized the BVI liquidation as a foreign main proceeding.

As a "primary asset" of Fairfield, the SIPA Claim was put up for auction in the BVI proceeding, and after competitive bidding, a company named Farnum Place, LLC ("Farnum") emerged as the successful bidder. Farnum had offered to purchase the SIPA Claim for 32.125% of its allowed amount, which was several percentage points higher than the competing bids. In December 2010, the BVI liquidator and Farnum signed a "trade confirmation" setting forth the material terms of the sale of the SIPA Claim. The trade confirmation stated that New York law would govern the transaction, and provided that the sale was subject to the approval by the BVI court and the bankruptcy court in New York.

Three days after the trade confirmation was signed, the BLMIS trustee in New York announced that he had settled an unrelated dispute, the result of which would bring $5 billion into the BLMIS estate and increase the potential recoveries of those holding allowed customer claims against BLMIS. As for the SIPA Claim specifically, the settlement boosted its value from 32.125% of its allowed amount to 50% of its allowed amount, an increase of about $40 million.

After that dramatic rise in value, the Fairfield liquidator failed to seek approval of the sale of the SIPA Claim to Farnum. Farnum thus took matters into its own hands, asking the BVI court to compel the liquidator to comply with the trade confirmation, or in the alternative, to grant Farnum leave to sue for specific performance. The Fairfield liquidator, in turn, asked the BVI court not to approve the sale of the SIPA Claim to Farnum because the sale was not in the best interest of Fairfield's estate, given the sudden increase in value. The BVI court ultimately approved the terms of the trade confirmation and the sale of the SIPA Claim to Farnum at the bid price. The BVI court nevertheless instructed the liquidator "to take the necessary steps to bring before the U. S. Bankruptcy Court the question of approval (or non-approval) by that Court of the Trade Confirma-

tion," while making "clear that it must be done in such a way that the U. S. Bankruptcy Court is presented with a choice whether or not to approve it."

The proceedings then shifted to the bankruptcy court in New York, where the Fairfield liquidator asked the court to disapprove the sale under Section 363 of the Bankruptcy Code. In particular, the liquidator argued that the sale failed to satisfy Section 363 because it lacked a "good business reason" in light of the SIPA Claim's precipitous jump in value. The bankruptcy court rejected the liquidator's request, holding that Chapter 15 of the Bankruptcy Code did not mandate the application of Section 363 because the sale did not "involve the transfer of an interest in property within the United States . . . ." In addition, the court explained, international comity was Chapter 15's "governing concept," and comity dictated that the court defer to the BVI court's approval of the sale. "Failing to grant such comity . . . under these circumstances," the court said, "necessarily undermines the equitable and orderly distribution of a debtor's property by transforming a domestic court into a foreign appellate court where creditors are always afforded the proverbial 'second bite at the apple.'"

Having lost in the bankruptcy court, the Fairfield liquidator appealed to the U. S. District Court for the Southern District of New York, which affirmed the bankruptcy court's ruling. On further appeal, the Second Circuit vacated the district court's decision and remanded with instructions to the bankruptcy court to review the merits of the sale under Section 363 of the Bankruptcy Code. The Second Circuit's decision addressed three issues: (1) whether the sale of the SIPA Claim involved a "transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States"; (2) the extent of international comity under Chapter 15; and (3) the legal standard that the bankruptcy court should apply on remand in its review of the sale under Section 363.

Territorial Jurisdiction

In Chapter 15 cases that are ancillary to a "foreign main proceeding," Section 1520(a)(2) of the Bankruptcy Code provides for Section 363 to "apply" to a "transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States to the same extent that . . . [Section 363] would apply to property of an estate" in a plenary case filed under Chapter 7 or Chapter 11 of the Bankruptcy Code. With respect to intangible property, Section 1502(8) of the Bankruptcy Code defines the phrase "within the territorial jurisdiction of the United States" to mean "intangible property deemed under applicable nonbankruptcy law to be located within that territory, including any property subject to attachment or garnishment that may properly be seized or garnished by an action in Federal or State court in the United States." Invoking New York law as the "applicable nonbankruptcy law," the Second Circuit determined that the SIPA Claim was "within the territorial jurisdiction of the United States" because it was "subject to attachment or garnishment and may be seized or garnished by an action" in the United States. Under New York law, "any property which could be assigned or transferred" was subject to attachment or garnishment. The SIPA Claim was assignable or transferrable property. For attachment purposes, the Second Circuit noted that the situs of intangible property that has as its subject a legal obligation to perform is the location of the party legally obligated to render that performance. Here, the court explained, the BLMIS trustee was obligated to

distribute to Fairfield, as holder of the SIPA Claim, its pro rata share of the recovered assets. Because the BLMIS trustee was located in New York, that state was the situs of the SIPA Claim.

The Second Circuit rejected Farnum's argument that the SIPA Claim could not be properly seized in the United States because such a seizure would be stayed by the BVI court. The court of appeals said that Farnum's argument "would render the 'subject to attachment or garnishment' phrase of section 1502(8) a nullity." As there "is always an automatic stay in bankruptcy proceedings," the Second Circuit reasoned, "it would make no sense if the existence of a stay could affect the construction of the term 'interest' under section 1502(8)." In addition, the Second Circuit noted that Section 1502(8) spoke of intangible property "deemed under applicable nonbankruptcy law" to be subject to attachment or garnishment. "This provision," said the court, "thus cannot be read to mean that the determination of whether section 363 review is necessary can be affected by factors that are the quintessential features of bankruptcy law," such as a stay of creditor actions. Thus, the court concluded, the sale of the SIPA Claim was a "transfer of an interest in property within the territorial jurisdiction of the United States." Accordingly, Section 363 of the Bankruptcy Code applied to the sale.

Comity

The Second Circuit also rejected the argument that considerations of international comity necessitated deference to the BVI court. While acknowledging that comity plays a role in Chapter 15 cases, the Second Circuit observed that "Chapter 15 does impose certain requirements and considerations that act as a brake or limitation on comity." One such requirement was the express command in Section 1520(a)(2) that Section 363 "apply ... to the same extent" as in bankruptcy cases filed under Chapter 7 or Chapter 11. "The language of section 1520(a)(2) is plain," noted the court. "[T]he bankruptcy court is required to conduct a section 363 review when the debtor seeks a transfer of an interest in property within the territorial jurisdiction of the United States." Furthermore, the Second Circuit observed, it was not "apparent at all that the BVI Court even expects or desires deference in this instance" since the BVI court directed the Fairfield liquidator to obtain a ruling on the proposed sale from the bankruptcy court. Thus, the bankruptcy court erred "when it gave deference to the BVI Court's approval of the transfer of the SIPA Claim and failed to conduct a review under section 363."

Section 363 Review

The Second Circuit remanded the case so that the bankruptcy court could consider the sale under Section 363. Although it gave no view of the merits of the proposed sale under Section 363, the Second Circuit nevertheless illuminated "some guiding principles from our case law" to facilitate the Section 363 review on remand. After reviewing the case law interpreting Section 363, the Second Circuit concluded that on remand "the bankruptcy court must consider as part of its section 363 review the increase in value of the SIPA Claim" that followed the signing of trade confirmation.

Comment

The Second Circuit's decision in Fairfield Sentry demonstrates that, despite being a "governing" or "central concept," the doctrine of international comity is not without limit in Chapter 15 cases. Because Section 1520(a) of the Bankruptcy Code requires that Section 363 "apply" to the transfer of an interest in property within the territorial jurisdiction of the United States, the Second Circuit determined that there was no basis for deferring to the BVI court on the sale. In sum, comity cannot trump the plain language of a statute that leaves no room for deference to a foreign proceeding. Such a holding is not without precedent. In a separate case predating the enactment of Chapter 15, Maxwell Communication Corp., the Second Circuit observed that, because "the principle of comity does not limit the legislature's power and is, in the final analysis, simply a rule of construction, it has no application where Congress has indicated otherwise." Although it did not cite to Maxwell in its Fairfield decision, the Second Circuit essentially ruled that Congress "indicated otherwise" when it enacted Section 1520(a)(2).