Clients&FriendsMemo

Second Circuit Denies Petition for *En Banc* Review of Fairfield Decision

January 16, 2015

On January 13, 2015, the U.S. Court of Appeals for the Second Circuit denied a petition for *en banc* review of the Second Circuit's September 2014 panel decision holding that bankruptcy courts are required to review the propriety of a Chapter 15 debtor's transfers of property interests within the territorial jurisdiction of the U.S., even if such a transfer has already been approved in the debtor's foreign proceeding. This decision represents a departure from prior cases, in which U.S. judges often enforced foreign court orders based on principles of comity and prohibited challengers from "re-litigating" such disputes in the U.S. Absent consideration and reversal by the U.S. Supreme Court, the Second Circuit's opinion and subsequent denial of *en banc* review could signal a paradigm shift in Chapter 15 jurisprudence and is sure to be cited with fervor by litigants in future Chapter 15 proceedings. The decision may also create new burdens or requirements for foreign liquidators using estate property located in the U.S.

Procedural History and Second Circuit's Panel Decision

Fairfield Sentry, Ltd. ("Fairfield") is a British Virgins Islands ("BVI") investment fund that invested approximately 95% of its assets with Bernard L. Madoff Investment Securities LLC ("BLMIS") prior to the financial crisis. Following exposure of the Madoff fraud and commencement of BLMIS's liquidation in December 2008 under the Securities Investor Protection Act, Fairfield entered into a settlement with the BLMIS trustee fixing its claims against BLMIS at $230 million (the "Fairfield Claims").

In July 2009, Fairfield voluntarily initiated liquidation proceedings in the BVI. Then, in 2010, the Fairfield foreign representative filed a Chapter 15 petition in the U.S. Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") requesting recognition of the BVI liquidation as a "foreign main proceeding," which was granted. Fairfield's foreign representative thereafter agreed to sell the Fairfield Claims to Farnum Place, LLC ("Farnum") for 32.125% of the claims' value, which was conditioned upon approval of the sale in both the BVI court and the Bankruptcy Court.

However, three days after the sale agreement was executed, the BLMIS trustee agreed to a massive settlement in the BLMIS proceeding that increased the value of the Fairfield Claims by approximately $40 million dollars. The Fairfield foreign representative, believing that the deal with Farnum was no longer in the estate's best interest, sought to unwind the sale of the Fairfield Claims in the BVI court. The BVI court rejected Fairfield's arguments, approved the sale, and directed the Fairfield foreign representative to bring the issue before the Bankruptcy Court, as required in the sale agreement. The Fairfield foreign representative requested that the Bankruptcy Court disallow the sale on the basis that it did not comply with Section 363 of the Bankruptcy Code, which is made applicable in Chapter 15 cases by virtue of Section 1520(a)(2) of the Bankruptcy Code.

The Bankruptcy Court rejected the foreign representative's arguments and approved the sale, reasoning that (a) principles of comity dictated that it defer to the BVI court and thus approve the sale,[1] and (b) a common sense appraisal indicated that the Fairfield Claims were located in the BVI and not "within the territorial jurisdiction of the United States" as set forth in Section 1520, because the BVI court had a principal role in overseeing Fairfield's liquidation, and therefore the sale was not subject to review under Section 363.[2] The Fairfield foreign representative then appealed to the U.S. District Court for the Southern District of New York (the "District Court"), which affirmed the Bankruptcy Court's decision, finding that it appropriately considered principles of comity.[3]

However, following another appeal by the Fairfield foreign representative, on September 26, 2014, the Second Circuit vacated the decisions by both the District Court and Bankruptcy Court and held that (a) under Section 1502(8) of the Bankruptcy Code, the Fairfield Claims were intangible properties subject to attachment or garnishment by the BLMIS trustee in New York, and therefore the *situs* of the Fairfield Claims was New York,[4] and (b) a plain reading of Section 1520(a)(2) of the Bankruptcy Code "required" a bankruptcy court to conduct a Section 363 review of any transfer of an interest of a debtor in property within the U.S.[5]

Petition for Rehearing *En Banc*

On October 10, 2014, Farnum filed a petition in the Second Circuit for rehearing *en banc*, arguing, among other things, that (a) the Fairfield Claims were interests located in the BVI, and (b) Section 1520 did not preclude application of comity principles to a Section 363 review, and certainly did

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1 See In re Fairfield Sentry Ltd., 484 B.R. 626–28 (Bankr. S.D.N.Y. 2013).

2 Id. at 615 and 623.

3 See Krys v. Farnum Place, LLC (In re Fairfield Sentry Ltd.), No. 13 Civ. 1524 (AKH) at 1, 2 (S.D.N.Y. July 3, 2013) [ECF No. 15].

4 See In re Fairfield Sentry Ltd., 768 F.3d 239, 244–45 (2d Cir. 2014).

5 Id. at 246.

not "evince any [Congressional] intent to overrule the centuries of international-relations law that formed the backdrop for Congress's enactment of Chapter 15."[6]

Notably, Farnum argued the *situs* of the Fairfield Claims was in the BVI because Fairfield was a BVI company undergoing liquidation in the BVI under the supervision of a BVI court pursuant to a BVI liquidator (who was himself a BVI resident).[7] Furthermore, any distribution on account of the Fairfield Claims would be subject to supervision by the BVI court. Consequently, Farnum argued that in light of Chapter 15's purpose of facilitating foreign proceedings, a "common sense appraisal" dictated that the *situs* of the Fairfield Claims was the BVI.

Farnum further argued that the Fairfield foreign representative was incorrect in his contention that principles of comity could not apply with respect to Section 1520. Specifically, Farnum argued that although Section 1520 provided that various provisions of the Bankruptcy Code, including Section 363, "apply" to a Chapter 15 ancillary proceeding, the use of the word "apply" was an example of "general words" that the Second Circuit had previously held, in a different but factually similar case, were "insufficient to express [a Congressional] intent to override the background rules of international comity . . . ."[8] Consequently, Farnum argued, "mere 'general words' " could not overcome "centuries of court-developed international law."[9]

In contrast, the Fairfield foreign representative argued that New York was the proper *situs* of the Fairfield Claims because (a) the BLMIS trustee was located in New York and was subject to garnishment under New York law, (b) New York courts had jurisdiction over the BLMIS property from which the Fairfield Claims would be satisfied, and (c) the Fairfield Claims would be paid from BLMIS property located in New York.[10]

The Fairfield foreign representative challenged the applicability of comity, arguing that Congress intended Section 363 to be "automatic" and "nondiscretionary" in its application to a recognized foreign main proceeding.[11] Reaching into the legislative history of both Section 1520 and the Model Law on Cross-Border Insolvency, upon which Chapter 15 is based, the Fairfield foreign representative argued that while certain provisions of Chapter 15 were discretionary, Section 1520

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6 Brief for Rehearing of Appellee at 16–17, In re Fairfield Sentry Ltd., No. 13-3000-bk (2d Cir. 2014) [ECF No. 96].

7 Id. at 24–25.

8 Id. at 37 (citing In re Maxwell Commc'n Corp. plc ex rel. Homan, 93 F.3d 1036, 1048–49 (2d Cir. 1996)).

9 Id.

10 Brief for Rehearing of Appellant at 29, In re Fairfield Sentry Ltd., No. 13-3000-bk (2d Cir. 2014) [ECF No. 99].

11 Id. at 33.

was an express Congressional command that could not be limited by the principle of comity, and had "no application where Congress has indicated otherwise."[12]

On January 13, 2015, the Second Circuit denied, without analysis, Farnum's petition for a rehearing *en banc*,[13] thereby reaffirming the Second Circuit panel and sending the matter back to the Bankruptcy Court to issue a ruling consistent with the Second Circuit's September 26, 2014 decision.

Impact of Second Circuit's Decision on Chapter 15 Cases

The Fairfield decision represents a directional shift from case law under Chapter 15 and its predecessor, Section 304 of the Bankruptcy Code. Prior to Fairfield, orders issued in a foreign proceeding were routinely viewed by U.S. bankruptcy judges as having *res judicata* effect in the U.S. and thus, challenges were permitted only if a creditor demonstrated that it did not receive adequate notice in the foreign proceeding or did not otherwise have an opportunity to participate in the foreign proceeding.[14] Now, parties seeking an independent review of a foreign order permitting a transfer or other actions affecting U.S. property may have a powerful new basis on which to object in the U.S. court. In Fairfield, the foreign representative sought such a review, but in the future such requests may be more likely to come from U.S. creditors, who are usually the parties that request Chapter 15 courts to override orders entered in a foreign proceeding. In addition, the Fairfield decision may give foreign representatives more requirements to satisfy and a higher burden to meet in the U.S. court before they can take actions with respect to the foreign debtor's U.S. property. In light of this, and other recent case law in the Second Circuit,[15] foreign representatives may carefully consider whether to seek Chapter 15 relief in the Second Circuit, where about 40% of all Chapter 15 cases have been filed.

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[12] Id. at 34–37.

[13] Kenneth Krys v. Farnum Place, LLC (In re Fairfield Sentry Ltd.), No. 13-3000-bk (2d Cir. Jan. 13, 2015) [ECF No. 102] (denying petition for rehearing *en banc*).

[14] See, e.g., In re Daewoo Motor of Am. v. Gen. Motors, 459 F.3d 1249, 1258–59 (Korean court judgment elevated to status of sister-state judgment based on comity); In re Telecom Argentina, No. 06 Civ. 2352, 2006 WL 3378687, at **5–6 (S.D.N.Y. 2006) (holding that a foreign court judgment was entitled to comity under Section 304, and therefore the matter was *res judicata* with respect to a creditor's objection in the U.S. court); In re Bd. of Dirs. of Hopewell Int'l Ins., 238 B.R. 25, 58–59 (Bankr. S.D.N.Y. 1999) (same).

[15] See Drawbridge Special Opportunities Fund LP v. Barnet (In re Barnet), 737 F.3d 238, 247–51 (2d Cir. 2013) (holding that a foreign representative is precluded from obtaining Chapter 15 recognition if the relevant foreign debtor does not have a residence, place of business, or property in the U.S.)

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