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Memorandum

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Second Circuit Holds That a Sale by a Chapter 15 Debtor in a Foreign Main Proceeding of a Claim Against an Obligor Located in the U.S. Must Be Reviewed by the U.S. Bankruptcy Court Under Section 363 of the Bankruptcy Code

On September 26, 2014, the United States Court of Appeals for the Second Circuit, overturning decisions by the Bankruptcy Court and the District Court for the Southern District of New York, held that the Bankruptcy Court was required to review under section 363 of the Bankruptcy Code the transfer of a claim by a chapter 15 debtor with a recognized foreign main proceeding pending in the British Virgin Islands (the "BVI").[1] In a case under chapter 15 of the Bankruptcy Code in which a foreign main proceeding has been recognized, section 1520(a)(2) of the Bankruptcy Code provides that section 363, including the need for Bankruptcy Court approval under that section, applies to "a transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States." The Second Circuit, disagreeing with the lower courts, ruled that the claim owned by the chapter 15 debtor is located in New York and, therefore, under sections 1520(a)(2) and 363, the claim could not be sold without Bankruptcy Court approval. The Second Circuit also ruled that comity did not warrant deference to a judgment of the British Virgin Islands court approving the transfer. The Second Circuit vacated and remanded with instructions to the Bankruptcy Court to analyze the transfer under section 363.

Background

Fairfield Sentry Limited ("Sentry"), a BVI entity, was an investor in Bernard L. Madoff Investment Securities ("Madoff"). When Madoff was placed into liquidation under the Securities Investor Protection Act ("SIPA"), Sentry, whose net losses from its Madoff investments were approximately $960 million, asserted claims against Madoff and Madoff asserted objections and counterclaims against Sentry. Sentry and the trustee in the Madoff SIPA proceeding (the "Madoff Trustee") agreed to a settlement that gave Sentry an allowed claim of $230 million against Madoff (the "Madoff Claim") to be paid from a fund established to pay claims (the "BLMIS Fund"), subject to a cash payment of $70 million to be paid by Sentry to the Madoff Trustee.

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1 *In re Fairfield Sentry Ltd.*, No. 13-3000, 2014 U.S. App. LEXIS 18427 (2d Cir. Sept. 26, 2014)

In 2009, Sentry itself was placed into liquidation in the High Court of Justice of the Eastern Caribbean Supreme Court (the "BVI Court") and Kenneth Krys was appointed as the liquidator. In July 2010, the Bankruptcy Court for the Southern District of New York granted a petition filed by Krys, as a foreign representative of Sentry, seeking recognition of the Sentry liquidation as a "foreign main proceeding" under chapter 15 of the Bankruptcy Code. After an auction process in December 2010, Krys accepted an offer from Farnum Place, LLC ("Farnum") to purchase Sentry's Madoff Claim for 32.125% of its allowed amount and the parties negotiated, documented and signed a trade confirmation (the "Trade Confirmation") setting forth the material terms and conditions of the sale, including that the sale was subject to approval by both the Bankruptcy Court and the BVI Court. Three days later, an unrelated settlement agreement in the Madoff SIPA liquidation was announced that provided significant value to the Madoff estate and increased the value of Sentry's Madoff Claim from 32% of the allowed amount to more than 50% of the allowed amount (an increase of approximately $40 million).

By October 2011, Krys had still not sought court approval of the sale of the Madoff Claim, so Farnum filed an application with the BVI Court seeking to compel Krys to satisfy the conditions of the Trade Confirmation. Krys, however, asked the BVI Court not to approve the transfer of the Madoff Claim to Farnum at the agreed price because the transfer was not in the best interests of the Sentry estate. Krys also argued that the Trade Confirmation required the approval of the Bankruptcy Court pursuant to sections 1520(a)(2) and 363 of the Bankruptcy Code.

In March 2012, the BVI Court approved the terms and conditions of the Trade Confirmation and the assignment of the Madoff Claim at the agreed price. The BVI Court also ordered Krys "to take the necessary steps to bring before the US Bankruptcy Court the question of approval (or non-approval) by that Court of the Trade Confirmation."[2] Krys then filed an application with the Bankruptcy Court seeking review of the Trade Confirmation under section 363, along with a proposed order disapproving the trade. The Bankruptcy Court characterized Krys' request to disapprove the trade as "seller's remorse"[3] and ruled that section 363 review was not warranted under section 1520(a)(2) because it found that the Madoff Claim was not *an interest of the debtor in property within the territorial jurisdiction of the United States*. The Bankruptcy Court stated further that comity dictates that it defer to the ruling of the BVI Court because failing to do so in these circumstances "necessarily undermines the equitable and orderly distribution of a debtor's property by transforming a domestic court into a foreign appellate court."[4] The District Court affirmed the Bankruptcy Court's decision[5] and Krys then appealed to the Second Circuit.

Application of Section 1520(a)(2)

On appeal, Krys argued that the sale of Sentry's Madoff Claim to Farnum was a transfer of an interest in property within the territorial jurisdiction of the United States because (1) the Madoff Claim is an interest in the BLMIS Fund, which is property located in the United States and (2) the Madoff Claim itself is property located in the United States. Farnum, in response, argued that the property at issue was the Madoff

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2 *Id.* at *7.

3 *In re Fairfield Sentry Ltd.*, 484 B.R. 615, 617 (Bankr. S.D.N.Y. 2013)

4 *Id.* at 628 (*quoting SNP Boat Serv. Sa v. Hotel Le St. James*, 483 B.R. 776, 786 (Bankr. S.D. Fla. 2012))

5 *In re Fairfield Sentry Ltd.*, No. 13 Civ. 1524 (AKH), (S.D.N.Y. Jul. 3, 2013) [Docket No. 15].

Claim, rather than the BLMIS Fund, and that the Madoff Claim was located in the BVI, outside the territorial jurisdiction of the United States.

The phrase "within the territorial jurisdiction of the United States" is defined in section 1502(8) of the Bankruptcy Code as:

> [T]angible property located within the territory of the United States and 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 a Federal or State court in the United States.[6]

The Second Circuit noted that under New York law "any property which could be assigned or transferred" is subject to attachment or garnishment and may be properly seized.[7] The Second Circuit also noted that "with respect to intangible property that has as its subject a legal obligation to perform, the situs is the location of the party of whom that performance is required pursuant to that obligation."[8] Because the Madoff Trustee was obligated to pay the Madoff Claim and the Madoff Trustee was located in New York, the Second Circuit ruled that the Madoff Claim was an interest in property within the territorial jurisdiction of the United States and, therefore, section 363 applies to the transfer of the Madoff Claim to Farnum.

Farnum argued that, even if the Madoff Claim's situs is New York, the Madoff Claim was not subject to an action of seizure or garnishment in the United States because any such action would be stayed by the BVI Court and the Bankruptcy Court. According to the Second Circuit, however, "this argument would render the 'subject to attachment or garnishment' phrase of section 1502(8) a nullity"[9] because there is always an automatic stay in bankruptcy proceedings.

Consideration of Comity

The Second Circuit acknowledged the importance of comity in chapter 15 cases, but ruled that "[t]he express statutory command that, in a Chapter 15 ancillary proceeding, the requirements of section 363 'apply…*to the same extent*' as in Chapter 7 or 11 proceedings" acts as a statutory limitation on comity.[10] The Second Circuit also commented that it was not apparent that the BVI Court expected deference in this case, as the BVI Court ordered Krys to seek approval from the Bankruptcy Court as required in the Trade Confirmation and expressly declined to rule on whether the Trade Confirmation required approval under section 363.

The Second Circuit vacated the District Court's decision and remanded it to the District Court with instructions to remand to the Bankruptcy Court to conduct a review of the transfer under section 363. While expressing no view on the merits of the section 363 review, the Second Circuit noted that the Bankruptcy Court is required to expressly find a good business reason to approve the sale and, in that

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6 11 U.S.C. § 1502(8).

7 N.Y. C.P.L.R. §§ 5201(b) and 6202.

8 *In re Fairfield Sentry Ltd.*, 2014 U.S. App. LEXIS 18427, at *12.

9 *Id.* at *13.

10 *Id.* at *14.

regard, it must consider the increase in the value of the Madoff Claim between the signing of the Trade Confirmation and approval by the Bankruptcy Court because nothing in the language of section 363 or case law limits the Bankruptcy Court's review to the date of the signing of the Trade Confirmation.

Implications

The Second Circuit's decision is significant for both sellers and purchasers of assets in chapter 15 bankruptcy cases. While chapter 15 is generally designed to give deference to foreign courts that administer foreign main proceedings, this decision highlights that such deference is not extended where there is a transfer of property within the territorial jurisdiction of the United States. For this purpose, when a chapter 15 debtor sells a cause of action or claim against a third party, the location of that intangible property is the place where the obligor is located. Given that U.S. bankruptcy court approval is required for such transactions, chapter 15 debtors may have the opportunity to back out of a sale that has been approved in a foreign jurisdiction if they determine that there is no longer a good business reason to proceed with the sale, such as when the property has increased in value or the chapter 15 debtor otherwise has a valid strategic business reason to not go ahead with the transaction. This decision also reminds bankruptcy courts that they should not defer to foreign court judgments approving the sale of U.S. assets on the basis of comity, but rather are required to analyze sales of U.S. assets under section 363 to the same extent that asset sales in chapter 7 or 11 cases are analyzed.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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