ALERTS

# Second Circuit Vacates Bankruptcy Court's Refusal to Review Foreign Debtor's Sale of U.S. Asset

**September 29, 2014**

The U.S. Court of Appeals for the Second Circuit, on Sept. 26, 2014, held that a U.S. bankruptcy court was required to conduct a full review of a foreign debtor's sale of property "within the territorial jurisdiction of the United States," relying on the "plain" language of Bankruptcy Code ("Code") Section 1520(a)(2) ("section 363 … [applies] … to a transfer of … property that is within the territorial jurisdiction of the United States to the same extent that the section … would apply to property of … an estate."). *In re Fairfield Sentry Ltd.*, 2014 WL 4783370, *4-5 (2d Cir. Sept. 26, 2014). The bankruptcy court also "erred when it gave deference to a foreign court's approval of the asset sale." *Id.* at *6.

The Second Circuit vacated bankruptcy and district court orders that declined to review a sale of the foreign debtor's asset, reasoning that the "bankruptcy court's analysis [was] incomplete." *Id.* at *4. In the mistaken view of the lower courts: (1) the foreign debtor was not selling a property interest "within the United States"; and (2) "comity dictate[d]" deference to a foreign court's judgment approving the sale. Remanding the matter back to the bankruptcy court, the court of appeals directed the court to "[consider] the [actual] increase in value of the … asset between" the contract signing "and approval [of the sale] by the bankruptcy court." *Id.* at *7. "Nothing in the [Code's] language … or [applicable] case law limits the … court's review to the date of signing the [contract]." *Id.* Given the large ($40 million) increase in the asset's value, the Second Circuit effectively directed the bankruptcy court on remand to reject the proposed asset sale, as the foreign Liquidator had requested.

# Relevance

*Fairfield Sentry* is important to asset buyers in bankruptcy sales. Until the bankruptcy court approves an asset sale, the selling trustee may decline to go forward if it has no "good business reason" for proceeding with the sale — if, for example, the property has increased in value, rendering the original contract price inadequate. A bankruptcy court's "principal responsibility … is to secure for the benefit of creditors the best possible bid." *Id.* at *6, citing *In re Fin. News Network Inc.*, 980 F.2d 165, 169 (2d Cir. 1992), and *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983).

Nor must a U.S. bankruptcy court defer to a foreign court's judgment as a matter of "comity." Despite Code Chapter 15's general deference to foreign courts for the sake of consistency, Section 1520(a)(2) explicitly "*required*" the bankruptcy court to review the asset sale "*to the same extent*" as it would in a domestic Chapter 7 or Chapter 11 case. *Id.* at *6 (emphasis in original).

# Facts

*U.S. Recognition of Sentry Case* Fairfield Sentry Ltd. ("Sentry") was a British Virgin Islands ("BVI") investment fund that had invested 95 percent of its assets with Bernard L. Madoff Investment Securities LLC ("Madoff"), the subject of a liquidation under the Securities Investor Protection Act ("SIPA"). After Sentry filed three customer claims in the Madoff SIPA liquidation (collectively, the "SIPA Claim"), the Madoff trustee and Sentry negotiated a settlement allowing Sentry's SIPA Claim in the amount of $230 million. Sentry itself later became the subject of a BVI liquidation, and a BVI court appointed the Liquidator under BVI law. The Liquidator then sought "recognition" of the BVI liquidation as a "foreign main proceeding" under Chapter 15 of the Code in the Southern District of New York. The bankruptcy court entered an order granting recognition of the Sentry case on July 22, 2010, enabling the Liquidator to use the U.S. bankruptcy court to protect and administer Sentry's assets in the United States (i.e., via automatic stay, injunctive relief, sale of property and operation of debtor's business).

## Auction of Sentry's SIPA Claim

The Sentry Liquidator auctioned off the Sentry SIPA Claim during the summer of 2010. The successful bidder ("Buyer") offered to buy the SIPA

Claim for roughly 32 percent of the claim's allowed amount, a bid that was "several percentage points higher than the other bids," and was accepted by the Liquidator, subject only to later court approval.

The Liquidator and Buyer negotiated, documented and signed a trade confirmation ("Contract") setting forth the material terms of the sale. Among other things, the Contract was to be governed by New York law and expressly "subject to approval by both the U.S. bankruptcy court and the BVI Court," with a requirement that the Liquidator promptly seek that approval.

## Increase in Value of SIPA Claim

Three days after the parties signed the Contract, the Madoff trustee entered into a settlement agreement with an unrelated third party that materially "increased the value of Sentry's SIPA Claim from 32% to more than 50% of the … allowed amount of the claim (an increase of approximately $40 million)." *Id.* at *2.

## BVI Court Approval of Contract Subject to U.S. Bankruptcy Court Approval

The Liquidator failed to seek BVI court approval of the Contract, causing the Buyer to move in the BVI court for an order compelling the Liquidator to comply with the Contract. In response, the Liquidator asked the BVI court "not to approve the transfer to [Buyer] at the bid price because, given the sudden increase in the value of the SIPA Claim, it was not in the best interests of the Sentry estate." *Id.* The Liquidator also argued that U.S. bankruptcy court approval was required under Code Sections 1520(a)(2) and 363. *Id.*

The BVI court approved the sale of the SIPA Claim under the Contract despite the Liquidator's objection, subject to further approval of the U.S. bankruptcy court. In doing so, it stressed that the U.S. bankruptcy court had "a choice whether or not to approve" the proposed sale. *Id.*

## U.S. Bankruptcy Court's Refusal to Review Contracts

The Liquidator moved in the U.S. bankruptcy court seeking review of the Contract and, more importantly, "an order *disapproving*" the sale (emphasis added). Denying the Liquidator's motion, the bankruptcy court described it as "seller's remorse" and a "last-ditch effort" to undo the sale.

It also declined to review the transaction because it reasoned that the "[s]ale does not involve the transfer of an interest in property within the United States." In its view, "comity dictates that [the U.S. bankruptcy court] defer to the BVI Judgment" by approving the sale. *Id.* at *3. On the first round of appeal, the district court questioned whether Code Section 363 even applied, but agreed that the bankruptcy court's denial of the Liquidator's challenge to the sale was proper because "[c]ourts should be loath to interfere with corporate decisions absent a showing of bad faith, self-interest, or gross negligence." *Id.*

### Chapter 15 Requires Full Bankruptcy Court Review

## The Court of Appeals

The BVI Liquidation was a "foreign main proceeding" under Chapter 15 of the Code, noted the Second Circuit. A U.S. bankruptcy court must therefore fully review any proposed "transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States." Code § 1520(a)(2). More importantly, Section 1520(a)(2) provides that the U.S. bankruptcy court must conduct its review "to the same extent that [Section 363] would apply to property of an estate" in a domestic case. *Id.* at *4.

### SIPA Claim Is Property

The Second Circuit rejected the parties' technical arguments over the nature of the SIPA Claim, holding that it was "property" and that Sentry was selling its "rights, title and interest in and to [its] claims against" Madoff in the Madoff SIPA liquidation. "In other words, the SIPA Claim is a 'chose in action.'" *Id.* at *4.

### SIPA Claim Within the United States

The SIPA Claim was also within the territorial jurisdiction of the United States, contrary to the bankruptcy court's finding. Code Section 1502(a) includes the following property "within the territorial jurisdiction of the United States": "[I]ntangible 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."

The bankruptcy court mistakenly held that the SIPA Claim was "located with the debtor in the BVI," and the Second Circuit found that analysis to be "incomplete." In fact, the SIPA Claim was "subject to attachment or garnishment and may be properly seized by an action in a Federal or State court in the United States." *Id.* at *4-5. Citing New York CPLR Sections 5201(b) and 6202, the court found that "any property which could be assigned or transferred" is subject to attachment and garnishment in New York. Here, the Madoff SIPA trustee was located in New York and was "statutorily obligated to distribute to Sentry its pro rata share of the recovered assets" on the allowed SIPA Claim. *Id.* at *5.

## Comity Not Applicable

The Court of Appeals also rejected the lower courts' deference to the BVI court's judgment approving the sale. Code Chapter 15, in its view, imposed "certain requirements and considerations that act as a brake or limitation on comity." *Id.* at *6, quoting *In re Vitro S.A.B. de C.V.*, 701 F.3d 1031, 1054 (5th Cir. 2012). In other words, there is no automatic blanket deference to foreign rulings. Because the "plain" language of Code Section 1520(a)(2) directed the U.S. bankruptcy court to apply Section 363 "to the same extent" as it would in a Chapter 7 or a Chapter 11 case, the bankruptcy court was "required to conduct" a full review of the proposed sale when, as was the case here, the debtor sought to sell a property interest within the territorial jurisdiction of the United States. As noted, the BVI court apparently never "expect[ed] or desire[d] deference" here. That court had "expressly declined to rule on whether the [asset sale] required approval under section 363." *Id.*

# Comment

*Fairfield Sentry* does not turn on foreign law, comity or international diplomacy. Nor is it a case of "seller's remorse," as the bankruptcy court unfairly charged. The BVI Liquidator was a fiduciary with an obligation to withdraw from the Contract once the SIPA Claim dramatically increased in value before any court approved the sale. Regardless of what the BVI court did, the U.S. bankruptcy court had an obligation to approve only the "best possible bid." *Id.* It had no "good business reason" and no valid legal reason for deferring to the BVI court's misjudgment. *Id.*

*Fairfield Sentry* is also consistent with precedent. The Second Circuit's 1983 *Lionel Corp.* decision established the standard for a debtor's asset

sale under Code Section 363(b): "The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him ... *a good business reason* to grant such an application ... [M]ost importantly ... [the judge should consider] *whether the asset is increasing or decreasing in value*." 722 F.2d at 1071 (emphasis added).

*Authored by Michael L. Cook .*

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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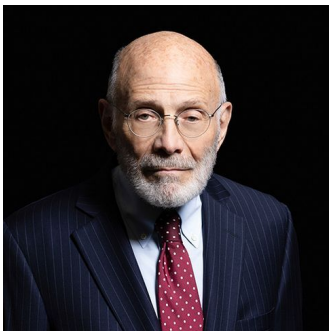

### Michael Cook

Of Counsel

New York

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