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In re Fairfield Sentry II: Testing the Brakes on Comity[1]

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On September 26, 2014, in the case of *In re Fairfield Sentry Ltd.,* the United States Court of Appeals for the Second Circuit (the 'Second Circuit') made an important holding regarding chapter 15 of the United States ('U.S.') Bankruptcy Code.[2] Reversing the decisions of the courts below, the Second Circuit held that bankruptcy courts were required to engage in a full review of sales of property located within the U.S. under section 363 of the Bankruptcy Code, even when the property was the subject of a foreign main proceeding under chapter 15 of the Bankruptcy Code *and* even when the sale had been approved by the overseas court. As the lower courts had not done such a review, the case was remanded to the Bankruptcy Court for the Southern District of New York ('Bankruptcy Court') so they could conduct one.[3]

On remand, the Bankruptcy Court, after engaging in a complete section 363(b) review, disaffirmed the disputed sale.[4] Since this ruling the case has made its way through the avenues of appeal once more. The Bankruptcy Court's decision was upheld by the District Court for the Southern District of New York ('District Court'),[5] and, returning to the Second Circuit, it was affirmed again.[6] Not content, the rejected would-be purchasers petitioned the Supreme Court of the United States ('Supreme Court') for a writ of certiorari.[7] On October 2, 2017, the Supreme Court denied the petition,[8] closing out the case once and for all. As such, it would appear that the Second Circuit's decision is set to remain good law and binding precedent on bankruptcy courts within the Second Circuit (including the Southern District of New York), at least for the time being. It remains to be seen, however, what the broader implications of this ruling will be, and whether through its potentially deleterious impact on international cooperation it is set to become something of a Banquo's ghost of international bankruptcy.[9]

Background and *Sentry I*

The *Fairfield* decisions arise from the collapse of Fairfield Sentry Limited ('Fairfield'), an investment fund formed in the British Virgin Islands ('BVI') which had invested 95% of its assets in Bernard L. Madoff Investment Securities LLC ('BLMIS'). When it became clear that this had not been a winning investment move, Fairfield entered liquidation proceedings in the BVI. Fairfield's liquidator (the 'Liquidator') accordingly filed a chapter 15 petition in the Bankruptcy Court in the U.S., seeking and receiving an order recognising the BVI liquidation proceeding as a 'foreign main proceeding' (the 'Recognition Order'), entitling it to certain levels of cooperation by U.S. courts.[10] Fairfield then filed a Securities Investor Protection Act ('SIPA') claim (the 'SIPA Claim') in the BLMIS liquidation, which was settled for USD 230 million.[11] It being unclear how much of that settlement would actually be paid out, the Liquidator auctioned and sold the SIPA Claim to Farnum Place, LLC ('Farnum') for 32.125% of its face value, and negotiated a 'Trade Confirmation' establishing the terms of the sale, including its being subject to approval by the BVI court *and* the U.S. Bankruptcy Court.

Notes

1 The views expressed herein are solely those of the authors, and not necessarily the views of Proskauer Rose LLP or any of its attorneys.
2 *In re Fairfield Sentry Ltd.,* 768 F.3d 239 (2d Cir. 2014) ('*Sentry I*').
3 *See* Geoffrey T. Raicht and Maja Zerjal, *Chapter 15: Expect Section 363 Review of Sales of Property Located in the US*, 12(3) Int.Corp.Rescue 181 (2015).
4 *In re Fairfield Sentry Ltd.*, 539 B.R. 658 (Bankr. S.D.N.Y. 2015).
5 *In re Fairfield Sentry Ltd.*, Case No. 15 Civ. 9474 (AKH) (S.D.N.Y. June 2, 2016) ECF No. 15.
6 *In re Fairfield Sentry Ltd.,* 690 Fed. Appx. 761 (2d Cir. 2017) ('*Sentry II*').
7 This is the most common method for appealing a case to the U.S. Supreme Court. If the U.S. Supreme Court wishes to hear the case it will grant the writ, otherwise the petition will be denied.
8 *In re Fairfield Sentry Ltd.*, Case No. 16-2127, (S. Ct. Oct. 2, 2017), ECF. No 83.
9 *Cf. In re Owens Corning,* 419 F.3d 195, 216 (3d Cir. 2005).
10 The Recognition Order was affirmed by the District Court and subsequently by the Second Circuit. *See Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.),* 714 F.3d 127 (2d Cir. 2013).
11 Subject to a cash payment of USD 70 million from Fairfield.

Three days after the signing of the Trade Confirmation, however, the SIPA trustee announced a settlement that increased the value of the SIPA claim to more than 50% of its face value, an increase of approximately USD 40 million. Unsurprisingly, the Liquidator became less enamoured with the sale to Farnum, and refused to seek court confirmation of it. Farnum, however, forced the issue, filing an application to confirm the sale in the BVI court, which, when ruling on the application, disregarded the substantial increase in the value of the claims and approved the sale. The BVI court, however, issued a further directive: 'that [the sale] must be done in such a way that the US Bankruptcy Court is presented with a choice of whether or not to approve it.'[12] The Liquidator seized on this wording, and quickly presented the Bankruptcy Court with that choice, seeking to disavow the sale. The Bankruptcy Court, however, took a dim view of what it thought was the Liquidator's 'seller's remorse' and 'last-ditch effort' to get out of the sale, and approved it regardless.[13]

The Bankruptcy Court's decision was approved by the District Court on appeal,[14] and the Liquidator appealed further to the Second Circuit. The Second Circuit reversed and remanded the case, holding that the SIPA claim, due to its being subject to 'attachment or garnishment' in the U.S., was within the territorial jurisdiction of the U.S.[15] Therefore, by virtue of section 1520(a)(2) of the Bankruptcy Code, and regardless of any considerations of comity, the Bankruptcy Court was *required* to conduct a section 363 review 'to the same extent' as in chapter 7 or 11.[16] Comity is important, but chapter 15 nonetheless imposed 'certain requirements and considerations that act as a brake or limitation on comity,'[17] and full compliance with section 363(b) is one of them. The Second Circuit sent the case back down to the Bankruptcy Court, 'intimat[ing] no view on the merits' while conspicuously intimating that the court should consider as an important factor the large increase in value of the SIPA Claim.[18]

Post-*Sentry I* developments

On remand, the Liquidator filed a motion to disapprove the sale, while Farnum, notwithstanding the decision of the Second Circuit, filed a motion seeking either (a) modification of the Recognition Order so as to eliminate the need for section 363 review, or (b) confirmation that the sale did not require section 363 review after all, due to section 1521(a)(5) of the Bankruptcy Code.[19] The Bankruptcy Court ruled in favour of the Liquidator, holding that there was a sound business reason for disapproving the sale: the Liquidator had already received almost USD 40 million more than Farnum was going to pay for the SIPA Claim, which it would have to turn over if the sale went through.[20] Therefore, 'the most important factor and the one factor the Second Circuit specifically directed this Court to consider plainly weighs against the approval of the sale.'[21] Further, considering other factors from the seminal case of *In re Lionel Corp.*,[22] the sale price was 'disproportionately low' to the true value of the claim, and disapproving the sale was in the best interests of the debtor's creditors as a whole.[23] Farnum raised concerns about a disapproval ruling undermining the integrity of the auction process. The Bankruptcy Court found these concerns to be inapt. The Bankruptcy Court was 'not being asked to reopen the auction' but rather 'to disapprove a bid that is woefully inadequate in light of changed circumstances.'[24] Farnum argued further that confirming the sale would, first, better assist the foreign proceeding and, second, provide creditors with greater certainty as the SIPA Claim settlement had not yet been approved by the Bankruptcy Court. These arguments also failed to convince: the 'Second Circuit concluded that [the Bankruptcy Court] was not required to defer to the BVI Court,' dispatching the first contention. Regarding the second contention, far from providing more certainty, the terms of the deal meant that if the SIPA claim was eventually disallowed, Farnum would end up paying '32.125% of zero,' or in other words, nothing, hardly a boon to creditors.[25] Therefore, under

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12 *Sentry I,* 768 F.3d at 243.
13 *In re Fairfield Sentry Ltd.,* 484 B.R. 615, 617, 618 (Bankr. S.D.N.Y. 2013).
14 *Sentry I,* 768 F.3d at 244-45.
15 11 U.S.C. § 1502(8).
16 *Sentry I,* 768 F.3d at 245-46.
17 *Id.* at 245.
18 *Id.,* at 246-47. A petition for an *en banc* rehearing was filed by Farnum and denied by the Second Circuit on January 13, 2015. *See Order, Krys v. Farnum Place LLC*, No. 13-3000 (2d Cir. Jan. 13, 2015), [ECF No. 102].
19 *In re Fairfiled Sentry, Ltd.,* 539 B.R. 658, 664-66 (Bankr. S.D.N.Y. 2015). The liquidator also challenged Farnum's standing, but this was cursorily dismissed by the Bankruptcy Court, on the ground that Farnum was a creditor of the estate no matter which way one looked at it, and had standing even if it was the only creditor opposed to the sale. *Id.,* at 667.
20 Further, there were other indicators suggesting that the claim may increase even further in value.
21 *Id.,* at 669.
22 *In re Lionel Corp.,* 722 F.2d 1063 (2d Cir. 1983).
23 *In re Fairfiled Sentry, Ltd.,* 539 B.R. at 669.
24 *Id.,* at 670.
25 *Id.,* at 671-72.

section 363(b), all factors pointed to the disapproval of the sale.[26]

Farnum, however, had moved on three grounds for a ruling allowing it to avoid a section 363(b) review completely, in what the Bankruptcy Court characterised as an attempted 'end run around the Second Circuit's mandate.'[27] First, according to Farnum, the chapter 15 case 'was never intended to serve as a forum . . . to undo transactions' the BVI court had approved and so the Recognition Order should be amended to ensure this did not happen by rewriting it to eliminate the need for section 363(b) review.[28] The Bankruptcy Court found that the Second Circuit's mandate did not foreclose on this argument, but, regardless, it was lacking on the merits. Farnum's argument was predicated on its assertion that a foreign representative could simply intend that section 363(b) did not apply. A foreign representative 'can no more 'opt out' of section 363 than can a debtor in possession in chapter 11 or a trustee under chapter 7.'[29] Section 363 applies, 'like it or not.'[30] Farnum had relied, in making this argument, on section 1520(a)(3), which, *inter alia*, allows the foreign representative to operate the debtor's business and exercise the powers of a trustee in line with section 363 'unless the court orders otherwise.' Farnum argued the court should order otherwise here and free the Liquidator from the constraints of section 363. The Second Circuit, however, had held that section 1520(a)(3) did not allow a court to 'gut' section 363. The fact that it entitled the court to order otherwise was irrelevant. The Second Circuit concluded that section 1520(a)(3) only allowed for the court to *limit* the foreign representative's powers, not expand them.[31]

Farnum's second argument was that the Recognition Order itself had 'entrusted' to the Liquidator the power to administer and realise Farnum's claim under section 1521(a)(5), thereby removing the need to seek section 363(b) approval. Section 1521(a)(5) of the Bankruptcy Code allows a court recognising a foreign bankruptcy proceeding to 'entrust' the 'administration or realization of all or part of the debtor's assets within the territorial jurisdiction of the United States to the foreign representative,' and thus Farnum argued that this entrustment, which had been contained in the Recognition Order, meant that section 363(b) review was unnecessary for the Liquidator to 'realize' assets. The Bankruptcy Court did not agree. Such an argument had been rejected by the Second Circuit by necessary implication.[32] But even if it had not been, it was wrong. Like a chapter 11 trustee or debtor in possession, assets could only be sold pursuant to section 363, regardless of the Recognition Order.

Farnum's third and final argument – that the sale was an ordinary course transaction, as the Liquidator by definition liquidates assets as part of its common practice, and so 363(b) review was unnecessary – had been rejected by implication by the Second Circuit. But even if it had not been, it was wrong. The Liquidator, as with any liquidator, may be in the business of liquidating assets. But it was irrelevant what business the *Liquidator* was in. The relevant 'ordinary course of business' is the business of Fairfield, and Fairfield was not in the business of liquidating its own assets. It invested money. Therefore actions taken to liquidate its estate were not actions made in the ordinary course of its business.[33] Indeed, the logical conclusion of Farnum's argument is that section 363(b) approval would never apply to any sale by a chapter 15 liquidator or even a chapter 7 trustee

Having lost on its arguments across the board, Farnum appealed. The District Court affirmed the Bankruptcy Court's disapproval of the same,[34] and Farnum brought the sale once more to the Second Circuit.

Sentry II: the Second Circuit's decision

Farnum's luck in the Second Circuit was no better this time than in *Sentry I*. The Court first agreed with the Bankruptcy Court in rejecting the 'entrustment' argument as barred by the Second Circuit's mandate in *Sentry I*, and even if it were not, as foundering on the 'plain language' of section 1520(a)(2), which states that section 363 'appl[ies] to a transfer of an interest in of the debtor in property that is within the territorial jurisdiction of the United States to the same extent that the section[] would apply' in chapter 7 or chapter 11.[35] The Second Circuit also dismissed Farnum's

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26 Further, the court found that factors from *In re Lionel Corp.* concerned about the circumvention of the voting and Chapter 11 process were not applicable in liquidations, and so could play no role here. *Id.*, 669, n.18. Farnum was also told to take its argument that the Liquidator had acted inequitably up with the BVI court. *Id.*, at 671-72.

27 *Id.*, at 672. Relitigating things foreclosed by the higher court's ruling and mandate in remanding the case to the lower court contravenes the 'mandate rule.' The mandate rule 'compels compliance in remand with the dictates of the superior court and forecloses relitigation of issues expressly or *impliedly* decided by the appellate court.' *United States v. Ben Zvi,* 242 F.3d 89, 95 (2d Cir. 2001) (emphasis in original).

28 *Id.*, at 672.

29 *Id.*, at 673.

30 *Id.*

31 *Id.*, at 672-73.

32 *Id.*, at 674.

33 *Id.*, at 675-76. The Court also denied certain discovery motions that Farnum made. *Id.*, at 676-77.

34

35 *Id.*, at 767-68.

repackaged argument that even if section 363 review was appropriate, comity should have at least been given near-dispositive weight in the section 363(b) analysis. This too the Second Circuit found barred by the *Sentry I* mandate,[36] the claimed danger to 'transnational cooperation' notwithstanding.[37]

Denial of certiorari

Not content with two bites at the apple in the Second Circuit, Farnum once again petitioned for certiorari to the U.S. Supreme Court. They contended that the two *Sentry* cases had upended the statutory scheme, and made the role of the U.S. courts 'to *hinder* [foreign proceedings] by interjecting U.S. review processes into foreign transactions that have already been approved by foreign courts,' contrary to the intent of Congress.[38] The writ was even backed by an *amici curiae* briefing by a group of interested scholars, who contended that the Second Circuit's decision in *Sentry II* was just not logical: among other things, it would lead to less cooperation with foreign *main* proceedings than *nonmain* proceedings[39] and would lead to foreign courts favouring their own interests in retaliation.[40] The Supreme Court, however, denied certiorari, closing this case once and for all.

The future

The *Sentry* saga provides useful takeaways for participants in cross border distressed asset markets. First, *Sentry I* is and will remain good law for the time being – there is no contrary Circuit court decision in the U.S. and *Sentry I* will be binding on all courts within the Second Circuit. Therefore, sales of property located in the U.S. and subject to a foreign bankruptcy proceeding will be subject to a full section 363(b) analysis and compliance will be a prerequisite for approval by U.S. courts. Second, while it is apparently clear that comity itself is not an overriding, dispositive factor in such a section 363(b) analysis, the extent to which it should play a role is not much developed, despite the amount of appellate ink spilled. *Sentry II* left open whether comity was a relevant factor at all in the section 363(b) analysis,[41] though the small amount of jurisprudence that has come after *Sentry I* might suggest it is not.[42] Third, the extent to which international cooperation may break down now that U.S. courts will do their own section 363(b) analyses in all cases involving U.S. property, as suggested by Farnum and the *amici curiae* brief, is not yet resolved. As the practical impact of these decisions on foreign cooperation and cross border transactions involving U.S. assets evolves and clarifies, other circuits may get the chance to decide whether to follow *Sentry I*, and ultimately set up the issue for a final say by the Supreme Court.

Notes

36 *In re Fairfield Sentry Ltd.,* 690 Fed. Appx. 761 (2d Cir. 2017).
37 *Id,* at 769.
38 *Farnum Place, LLC v. Krys,* Case No. 17-285, 2017 WL 3635426 *1-3 (Aug. 21, 2017).
39 *Farnum Place, LLC v. Krys,* Case No. 17-285, 2017 WL 4117827 *9 (Sep. 15, 2017).
40 *Id.*, at *16.
41 *In re Fairfield Sentry Ltd.,* 690 Fed. Appx. 761, 769 n.5 (2d Cir. 2017).
42 *See, e.g., In re Fairfield Sentry, Ltd.,* 539 B.R. 658 (Bankr. S.D.N.Y. 2015); *In re Hanjin Shipping Co.,* 2016 Bankr. LEXIS 3986 *17 (D.N.J. 2016) ('Although comity is a principal objective of Chapter 15, deference to comity is not without limit. Courts have ruled that deference to a foreign tribunal in accordance with international norms cannot override the plain language of the Bankruptcy Code *when the language leaves no room for deference or discretion by the bankruptcy courts*.') (emphasis added). It must be said, *In re Fairfield Sentry* hardly seemed a model case to try this issue, given that the BVI court expressly left it up to the U.S. court to decide whether the sale should go ahead.

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