WILMERHALE

A "Second Bite" from the Second Circuit: Revisiting Section 363 Review of Transfers in Chapter 15 Bankruptcy Cases

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In a recent Madoff-related decision,[1] the Second Circuit ruled that a bankruptcy court in a chapter 15 case must conduct an independent review of an asset sale by a foreign liquidator, previously approved by a foreign court. In doing so, the Second Circuit also ruled that the bankruptcy court must perform that independent review as of the date the asset sale comes before the court, and not as of the date the asset sale was agreed by the parties or the date it was approved by the foreign court. Through this decision in the *Fairfield* case, the Second Circuit appears to expand the role of the bankruptcy court in chapter 15 cases and aligns, in some respects, with a recent decision of the Delaware bankruptcy court on similar matters.

Lower Courts Cast a Cold Eye on Fairfield's "Seller's Remorse"

We reported in earlier alerts[2] on the decisions of the Southern District of New York bankruptcy court and district court in respect of the transfer of a claim of Fairfield Sentry Limited, a Madoff feeder fund ("Fairfield"), against the liquidation estate of Bernard L. Madoff Investment Securities, LLC ("BLMIS"). In brief, Fairfield had agreed to sell its $230 million claim against BLMIS to Farnum Place, LLC ("Farnum") for a price equal to 32.125% of the face amount of the claim. That agreement to sell came just days before the BLMIS trustee announced a litigation settlement that increased the market value of the claim to more than 50% of its face amount.

The sale of the claim from Fairfield to Farnum was expressly subject to the approval of both the British Virgin Islands (BVI) court overseeing the liquidation of Fairfield and the US bankruptcy court overseeing the related chapter 15 bankruptcy case of Fairfield. The BVI court approved the sale, despite Fairfield's attempt to unwind its own agreement, subject to the further approval of the US court.[3] The US bankruptcy court declined to re-evaluate the sale, again over Fairfield's objection, and deferred to the BVI court's prior approval.[4]

The US bankruptcy court's decision was based on two principles: (1) that the claim was not an asset located in the United States, and therefore its transfer was not properly analyzed under US bankruptcy law, and (2) the US bankruptcy court should extend comity to the BVI court's decision to

approve the sale, and not question the BVI court's judgment. The US bankruptcy court refused to allow Fairfield to get a "second bite at the apple." It did not permit Fairfield to question the price at which it had agreed to sell the claim based on an increase in the market value of the claim between the date the deal was signed and the date the transaction came before the US bankruptcy court for approval. The US district court affirmed the US bankruptcy court's decision.[5]

Second Circuit Adopts a Broader Rule for US Review of Sale Transactions

On appeal to the Second Circuit, the US district court's ruling was reversed. In a decision entered on September 26, 2014, the Second Circuit first ruled that the transferred claim was located in the US, under section 1502(8) of the US Bankruptcy Code, because the claim is property that could be attached through an action in a US court. The claim was subject to such attachment in a US court because the obligor on the claim, the liquidation trustee for BLMIS, is located in New York, and because the *situs* of the obligor controls the ability to attach the asset in a US court action.

The Second Circuit next ruled that US courts reviewing sales of assets in chapter 15 cases need not defer, on the basis of comity, to prior court approvals of asset sales involving US assets. Indeed, the Second Circuit held that US courts are *required* to review such assets sales under the standards for asset sale review contained in section 363 of the US Bankruptcy Code, because of the mandate contained in section 1520(a)(2) of the US Bankruptcy Code. They may not use comity as an excuse to avoid that statutory mandate.[6] Moreover, the Second Circuit explained that on the facts of the case at hand, the BVI court actually invited a separate review by the US courts of the claim sale—so any discretion that may have existed for the US court to decline such a separate view was not properly exercised here.

If the Second Circuit's decision stopped here—with a ruling that the BLMIS claim was a US asset subject to section 363 review—then it would be interesting to that extent alone. It would more closely align the approach in New York bankruptcy courts to the approach in Delaware bankruptcy courts in cases such as *Elpida*,[7] in which separate review of asset sales previously approved by foreign courts seems more liberally conducted. But the Second Circuit did not stop there. In addition to remanding to the lower courts for review of the asset sale under section 363, the Second Circuit went the extra step to say that the lower courts *must* take into account the increase in the value of the claim between the time the asset sale transaction was agreed between the parties and the time that the proposed sale transaction was brought to the US court for approval. In other words, the lower courts cannot limit their review to whether the 32.125% price was a good deal for Fairfield when that deal was signed. Rather, the lower courts must consider whether the increase in price following the date the deal was signed gives reason to decline approval of the deal. On the facts of the Fairfield case itself, it is hard to believe that the lower court review ordered by the Second Circuit will result in approval of the sale, because the increase in the market value of the claim would—if the sale at the lower, agreed price were approved—result in a substantial lost opportunity to the creditors of the Fairfield estate. For this reason, the Second Circuit's opinion, when applied to the Fairfield facts, may result in both a further review and a disapproval of the sale, in contrast to *Elpida*, where the further review of the sale did not disrupt its prior Japanese court approval.

The section 363 analysis of the Second Circuit could have implications beyond the chapter 15 context as well. For example, on some occasions, the value of assets subject to a pending section 363 sale increases from the time an auction ends to the time the sale approval hearing occurs (whether because of extrinsic events, as in *Fairfield*, or because a new buyer or offer emerges). The Second Circuit's "second bite" ruling in *Fairfield* could be cited by seller debtors and trustees seeking to revisit such a sale even following the conclusion of an auction (though counterarguments regarding the sanctity of a court-approved auction process may also exist). The ruling also encourages buyers to obtain court approval as soon as possible after an agreement to purchase an asset in bankruptcy (or after the conclusion of an auction), because the "second bite" is not an option that is equally afforded to buyers.

The Bottom Line

The Second Circuit has taken a relatively aggressive stance on US court review of asset sales in chapter 15 cases. The Second Circuit has not just mandated separate review of certain asset sales by US courts following approval of those sales by the courts overseeing the related foreign liquidations. The Second Circuit has also mandated a standard of review that seems less likely, in some instances, to result in the US court affirming the foreign court's approval of the asset sale. While these mandates only apply where sales of US assets are at issue, the location of intangible assets continues to be a somewhat flexible concept. Therefore, at least in some respects, the Second Circuit's recent decision in *Fairfield* appears, directionally, to be expanding the role of US courts in chapter 15 cases, at the marginal expense of a more "universalist" approach to cross-border insolvency. In addition, the Second Circuit's ruling on the standard of review under section 363 may have effects in bankruptcy cases outside chapter 15.

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[1] *Krys v. Farnum Place, LLC (In re Fairfield Sentry Ltd.)*, No. 13-3000, 2014 WL 4783370 (2d Cir. Sept. 26, 2014).

[2] Jurisdictional Mix-and-Match: *Vitro*, *Elpida* and *Fairfield* Demonstrate the Uncertainties of Cross-Border Bankruptcy for US Bondholders and Buyers (Feb. 13, 2013); Cross-Border Bankruptcy in 2013: 10 Decisions Shaping Chapter 15 (Jan. 30, 2014).

[3] *See In re Fairfield Sentry Ltd.*, 484 B.R. 615, 622 (Bankr. S.D.N.Y. 2013).

[4] *Id*. at 627-628.

[5] *Krys v. Farnum Place, LLC (In re Fairfield Sentry Ltd.)*, No. 13 Civ. 1524 (AKH) (S.D.N.Y. Jul 3, 2013).

[6] Section 1520(a)(2) of the US Bankruptcy Code specifies those sections of the Bankruptcy Code

that are mandatorily applicable in a chapter 15 case recognized as a foreign main proceeding, including section 363.

[7] *In re Elpida Memory, Inc.*, Case No. 12-10947 (CSS), 2012 WL 6090194 (Nov. 20, 2012).

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