In re Fairfield Sentry – Narrow grounds to modify Chapter 15 recognition order do not include inconsistent positions taken by foreign representative

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Once recognition of a foreign proceeding under Chapter 15 has been granted under Bankruptcy Code section 1517, it can only be modified or terminated in certain limited circumstances.[1] A recent ruling by the Bankruptcy Court for the Southern District of New York (the 'Bankruptcy Court') in *In re Fairfield Sentry Ltd*, 539 BR 658 ('Banks SDNY 2015') illustrates just how narrow the grounds for modification of a recognition order are – allegations of manipulation of the Chapter 15 process and inconsistent positions taken by a foreign representative do not provide cause for modification absent a showing that the underlying grounds for recognition were lacking at the time recognition was granted or have since ceased to exist.[2]

Second Circuit decision: sale is subject to section 363 review

In September 2014, the Second Circuit Court of Appeals in *Krys v Farnum Place, LLC (In re Fairfield Sentry Ltd)*, 768 F3d 239 (2d Cir 2014) ('*Fairfield Sentry*') held that the sale by the foreign representative (the 'Foreign Representative') of Fairfield Sentry's customer claim (the 'Sentry Claim') in the Bernard L Madoff Investment Securities LLC liquidation to Farnum Place, LLC ('Farnum') must be reviewed by the Chapter 15 Bankruptcy Court under section 363 of the Bankruptcy Code, notwithstanding that the sale had been approved by the court presiding in the foreign main proceeding (the 'BVI Court') and despite arguments that subjecting the sale to such a review would run afoul of well-established principles of comity.[3] The Second Circuit held that, once the territorial prerequisite in Bankruptcy Code section 1520 had been satisfied, review under Bankruptcy Code section 363 was automatic and required. In other words, the mandate of Bankruptcy Code section 1520 trumped principles of comity and deference that would otherwise be afforded to the BVI Court.[4]

On remand: section 363 review

On remand to the Bankruptcy Court for the Southern District of New York (the 'Bankruptcy Court'), the sale of the Sentry Claim was overturned after failing to withstand scrutiny under the Second Circuit's requirements for a section 363 sale.[5]

Section 363(b) of the Bankruptcy Code provides that the 'trustee, after notice and hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate'.[6] The Second Circuit has 'identified a non-exclusive list of "salient factors" the bankruptcy judge should consider when deciding if the trustee has shown a sound business reason for the

relief he seeks' including, inter alia, 'the proceeds to be obtained from the disposition vis-à-vis any appraisals of the property. . . and, *most importantly perhaps, whether the asset is increasing or decreasing in value.*'[7] It is without cavil that Bankruptcy Courts have 'broad discretion and flexibility. . . to enhance the value of the estates before [them]'.[8]

On remand, the Bankruptcy Court determined that, while the terms of the deal between the Foreign Representative and Farnum made economic sense at the time they were made, at the time of review 'there was no business justification to proceed with the Trade Confirmation'.[9] If allowed to stand, the distributions that Farnum would receive on the Sentry Claim would exceed the purchase price by in excess of US$38m.[10] Noting that the 'most important factor' in determining whether to approve a sale under section 363 – namely, whether the asset is increasing or decreasing in value – 'plainly weighs against the approval of the sale', the Bankruptcy Court granted the Foreign Representative's motion and disapproved the sale.[11] In so doing, the Bankruptcy Court held that the Foreign Representative had 'exercised appropriate business judgment and provided a sound business reason for seeking disapproval of the Trade Confirmation'.[12]

To modify or not to modify

The Bankruptcy Court had to address a number of arguments made by Farnum by separate motion that if successful would have precluded section 363 review.[13] At the heart of Farnum's opposition was the assertion that the Foreign Representative's decision to subject the sale of the Sentry Claim to review by the Bankruptcy Court was nothing more than 'gamesmanship'.[14] According to Farnum, with the sole exception of the sale of the Sentry Claim, the Foreign Representative had never sought approval from the Bankruptcy Court for any transaction that the BVI Court had already addressed and approved.[15] As a result, Farnum argued that the Foreign Representative was improperly using the Chapter 15 process to 'second guess decisions of the BVI Court'.[16]

To remedy this alleged manipulation of the Chapter 15 process, Farnum sought an order from the Bankruptcy Court under Bankruptcy Code section 1517(d) modifying the order recognising the Chapter 15 proceedings (the 'Recognition Order') to expressly provide that any transactions previously approved by the BVI Court would not be subject to Bankruptcy Code section 1520(a)(2) and the related section 363 review.[17] According to Farnum, this modification of the Recognition Order would prevent the Foreign Representative from being able to 'unwind transactions he entered into that he no longer likes' while simultaneously 'honor[ing] the comity principles of Chapter 15'.[18]

Ultimately, the court found that the grounds for modification under section 1517(d) were not present and held that Farnum's arguments were nothing more than an 'attempt[] [to] end run . . . the Second Circuit's mandate.'[19]

Modification (or termination) of orders of recognition is permitted under section 1517(d) of the Bankruptcy Code, 'if it is shown that the grounds for granting it were fully or partially lacking or have ceased to exist'.[20] However, 'in considering such action[,] the court shall give due weight to possible prejudice to parties that have relied upon the order granting recognition.'[21] Courts have held that '[t]he same factors relevant in determining whether to grant recognition are. . . relevant in determining whether to terminate a recognition order.'[22]

Under section 1517(d), modification or termination of recognition under Chapter 15 is only appropriate in limited circumstances, such as where the underlying grounds for granting the relief have dissipated or if (as provided for in Bankruptcy Code section 1506, made applicable to recognition orders in section 1517(a)) continued recognition 'would be manifestly contrary to the public policy of the United States'.[23] For example, modification or termination would be appropriate where 'the recognized foreign proceeding has been terminated or its nature has changed'.[24] Similarly, modification or termination may be appropriate if new facts have arisen 'that require or justify a change of the court's decision, for example, if the foreign representative disregarded the conditions under which the court granted relief.'[25] Inconsistent positions taken by a foreign representative in a Chapter 15 case, while concerning and perhaps calling for sanctions or further scrutiny, do not alone meet the grounds for modification or termination of a recognition order under section 1517(d).[26]

The relief available under section 1517(d) is narrowly tailored and only available if the grounds for granting recognition were lacking or have ceased to exist. As no such allegations had been made, and the grounds for recognition in *Fairfield Sentry* had not changed, the Bankruptcy Court dispensed with Farnum's modification motion.

Notably, even in circumstances where the grounds for granting recognition have changed or ceased to exist, relief under section 1517(d) is only permissible if the prejudice resulting from the modification or termination is outweighed by the benefits of such modification or termination.[27] In *Fairfield Sentry*, Farnum made no such showing. In contrast, the Foreign Representative provided evidence of the prejudice to the creditors, shareholders and stakeholders of Sentry that would result if the sale were not subject to scrutiny under section 363.[28] If the sale was allowed to stand, a valuable asset would have

been sold for significantly less than its value, and the funds available for distribution to creditors would be diminished.[29] As one of the principle objectives of Chapter 15 is the 'protection and maximisation of the value of the debtor's assets' for the benefit of the interest of creditors and other stakeholders, the prejudice resulting from the requested modification of the Recognition Order would clearly outweigh any benefits of such modification.[30]

Conclusion

The decision of the Bankruptcy Court to deny the modification requested by Farnum was the correct one; this was not a 'close call'. While Farnum may have had valid concerns about the Foreign Representative's alleged manipulation of the Chapter 15 process and the conflict between well-established principles of comity and the extension of section 363 review to the sale of the Sentry Claim, it essentially lost those arguments when the Second Circuit held that, notwithstanding the concerns of the parties that deference should be afforded to the decision of the BVI Court to approve the sale, the Bankruptcy Court was required to review the transaction under section 363. On remand, the Bankruptcy Court correctly applied the factors governing such review, and determined that the sale did not pass muster. Farnum's request for modification was a seemingly last ditch effort to end run the Second Circuit's section 363 determination and, without any grounds under section 1517(d) for such modification, was doomed to fail.

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Notes

1 The statute speaks in terms of modifying or terminating *recognition*, not of the order granting recognition. The House Report that accompanied the enactment of chapter 15 explains: 'Consistent with the position of various civil law representatives in the drafting of the Model Law, recognition creates a status with the effects set forth in section 1520, so those effects are not viewed as orders to be modified, as are orders granting relief under sections 1519 and 1521. Subsection (4) states the grounds for modifying or terminating recognition. On the other hand, the effects of recognition (found in section 1520 and including an automatic stay) are subject to modification under section 362(d), made applicable by section 1520(2), which permits relief from the automatic stay of section 1520 for cause.' HR Rep 109, p 113, 109th Congress (2005).
2 Section 1517(d) provides, in pertinent part: '**(d)** The provisions of this subchapter do not prevent modification or termination of recognition if it is shown that the grounds for granting it were fully or partially lacking or have ceased to exist, but in considering such action the court shall give due weight to possible prejudice to parties that have relied upon the order granting recognition.'
3 The authors have previously criticised the refusal to apply principles of comity to the BVI Court's approval of the claim sale. See Law 360, 2nd Circuit Fails To See the Comity In Chapter 15, 20 October 2014.
4 In the authors' view, the procedural requirements for a sale imposed by section 363 – notice and a hearing – apply but do not otherwise obviate principles of comity.
5 See *Fairfield Sentry*, 539 BR at 671–72.
6 11 USC s 363(b).
7 *Fairfield Sentry*, 539 BR at 668 (quoting *Comm of Equity Sec Holders v Lionel Corp (In re Lionel Corp)*, 722 F2d 1063, 1071 (2d Cir 1983)).
8 *Ibid* (quoting *Consumer News & Bus Channel P'ship v Fin News Network Inc (In re Fin News Network Inc)*, 980 F2d 165, 169 (2d Cir 1992)).
9 *Ibid*, at 665.
10 *Ibid*, at 669.
11 *Ibid*. In determining that the sale could not be approved under 11 USC s 363, the Bankruptcy Court also dismissed several other arguments by Farnum, including an argument that upholding the sale transaction would serve the interests of comity. *See ibid* at 670. While Farnum argued that approval of the sale would 'best aid the BVI liquidation proceeding' because the BVI Court had already approved the transaction, the Bankruptcy Court noted that the Second Circuit had already concluded that it the Bankruptcy Court 'was not required to defer to the BVI Court and was required to perform an independent review under Bankruptcy Code section 363.' *Ibid*. The Bankruptcy Court also rejected arguments by Farnum that approval of the sale transaction would provide Sentry creditors with greater certainty of recovery and that the Bankruptcy Court should 'factor in the Foreign Representative's inequitable conduct' in determining whether to uphold the sale. *Ibid* at 670–71.
12 *Ibid*, at 672.
13 See *Motion of Farnum Place, LLC Requesting (i) Modification of Recognition Order and (ii) Confirmation That Sale of Sentry Claim Does Not Require Review Under Bankruptcy Code § 1520(a)(2)* (No 10-13164 (SMB), Bankr SDNY,13 February 2015 [DI 757]).
14 *Ibid*, at 27–29.
15 *Ibid*, at 13.
16 *Ibid*, at 3.
17 The parties and the Bankruptcy Court speak of modifying the Recognition Order notwithstanding the construct adopted in the statute of modifying recognition. See n1 above.
18 See n13 above, at 29.
19 *Fairfield Sentry*, 539 BR at 672.
20 11 USC s 1517(d).
21 *Ibid*.
22 *In re Cozumel Caribe, SA de CV*, 508 BR 330, 335 (Bankr SDNY 2014).
23 Courts have cautioned against the use of the public policy exception embodied in s 1506 in the context of requests for modification or termination of recognition orders, holding that the exception 'should be "narrowly interpreted as the word 'manifestly' in international usage restricts the public policy exception to the most fundamental policies of the United States."' *Cozumel Caribe, SA de CV*, 508 BR at 337 (quoting *In re Ephedra Prods Liab Litig*, 349 BR 333, 336 (SDNY 2006) (citing HR Rep No 109—31(I) at 109, *reprinted in* 2005 USCCAN 88, 172)).
24 UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation (1997), at para 165.
25 *Ibid*.
26 See *Cozumel Caribe, SA de CV*, 508 BR at 335–36.
27 11 USC s 1517(d).
28 See *Foreign Representative's Objection To Farnum Place, LLC's Motion Seeking (i) Modification of Recognition Order and (ii) Confirmation That Sale of Sentry Claim Does Not Require Review Under Bankruptcy Code § 1520(a)(2)* at 26 (No 10-13164 (SMB), Bankr SDNY, 3 March 2015 [DI 767]) ('Foreign Representative Objection').
29 *Ibid*.
30 *Ibid* at 27.