

New York bankruptcy court flexes global muscle

Can a non-US creditor maintain a lawsuit in its own jurisdiction against a US-based Chapter 11 debtor?



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THE QUESTION IS WHETHER A NON-US CREDITOR CAN MAINTAIN A LAWSUIT IN ITS OWN JURISDICTION AGAINST A US-BASED CHAPTER 11 DEBTOR



On 4 May 2012, the United States District Court for the Southern District of New York affirmed a 2011 Bankruptcy Court ruling, which enjoined a lawsuit in the Cayman Islands against a Chapter 11 debtor. The case of *Bernard L. Madoff Investment Securities, LLC v. Maxam Absolute Return Fund, et al.*, arises in the Bernie Madoff SIPA liquidation and Chapter 11 proceedings, where the aftermath of the massive Madoff fraud is playing out.

The question in this Madoff case is whether a non-US creditor can maintain a lawsuit in its own jurisdiction against a US-based Chapter 11 debtor. In this instance, can a Cayman Islands registered entity sue a Chapter 11 debtor in the Cayman Islands, and does the automatic stay of Section 362 of the Bankruptcy Code prohibit the lawsuit?

Section 362 provides:

... this section ... operates as a stay, applicable to all entities, of ... the commencement ... of a judicial ... proceeding against the debtor ... or to recover a claim ... or [added] any act to obtain possession of property of the estate ...

Section 541 of the Bankruptcy Code defines “property of the estate” as all of the legal or equitable interests of the debtor in property “wherever located”.

Madoff Securities was a member of SIPC, the Securities Investor Protection Corporation, formed under SIPA, the Securities Investor Protection Act, passed by the US Congress in 1970. SIPA and SIPC were designed to

protect customers of failed brokerage firms by providing a specialised liquidation proceeding, known as a SIPA liquidation, which is distinct from a US Chapter 7 liquidation proceeding. Madoff Securities is currently in a Chapter 11 proceeding, both of which have been substantively consolidated. Irving Picard was appointed as the Trustee on behalf of the liquidation estates. The cases are pending in the Southern District of New York. One of Picard’s duties is to recover assets for the benefit of defrauded customers of Madoff Securities, which assets include claims against third parties.

On 8 December 2010, the Madoff Trustee sued MAXAM Capital Management, LLC, MAXAM Absolute Return Fund, LTD and affiliates (“MAXAM”) in the New York Bankruptcy Court to recover preference payments totaling \$25 million, allegedly paid to MAXAM within 90 days prior to the Madoff Chapter 11 filing. Briefly, a “preference” arises under Section 547 of the Bankruptcy Code and is a pre-petition payment to creditor made within 90 days prior to a Chapter 11 filing. The US Bankruptcy Code provides for the recovery by the debtor’s estate of payments made on the “eve” of insolvency so that value can be more equitably re-distributed to all creditors. Upon being sued by the Madoff Trustee, the MAXAM defendants filed an answer in the New York preference case, but also filed a declaratory judgment action against the Trustee in the Cayman Islands. The purpose of the declaratory judgment action was

to obtain a court order in the Cayman Islands ruling the MAXAM defendants had no preference liability in the US proceedings.

In response to the Cayman Islands lawsuit, the Madoff Trustee filed a motion to enjoin the action, on the grounds that the action violated the automatic stay of Section 362 of the Bankruptcy Code, and Section 78 of SIPA, that prohibits legal action against the Trustee, as SIPA reserves exclusive jurisdiction to the US Courts. In a well-reasoned, 21-page opinion, the New York Bankruptcy Court on 12 October 2011, ruled the Cayman Islands action violated the automatic stay of Section 362 and applicable SIPA provisions. The New York Court found the Cayman Islands action to be void, and enjoined the MAXAM entities from taking any further action against the Madoff estate “in any domestic or extraterritorial jurisdiction” without first obtaining permission from the US Bankruptcy Court. In essence, the US Bankruptcy Court viewed the Cayman Islands action as an attempt to usurp the Bankruptcy Court’s jurisdiction over an asset of the Madoff Securities’ estates.

The MAXAM entities appealed the Bankruptcy Court ruling, but the US District Court affirmed the Bankruptcy Court ruling. In the appeal, the MAXAM entities argued that the automatic stay of Section 362 (as well as applicable SIPA provisions) had no extraterritorial effect, and could not apply or be enforced outside the US. The MAXAM entities further argued that the US Bankruptcy Court should have deferred to the Cayman Islands

court under principles of “comity”. In affirming the Bankruptcy Court ruling, however, the US District Court emphasized several points:

1. Under Section 541 of the Bankruptcy Code, defining “property of the estate”, the filing of Chapter 11 creates a worldwide estate of all of the legal or equitable interests, “wherever located”, with the implication that the Bankruptcy Court has exclusive jurisdiction over “property of the estate” anywhere.
2. The automatic stay (of Section 362) exists to protect the estate from a chaotic and uncontrolled scramble for the Debtor’s assets in a variety of uncoordinated proceedings in different courts, whether domestic or foreign.
3. “Comity” in the legal sense is neither a matter of absolute

obligation, on the one hand, nor of mere courtesy and goodwill upon the other. But it is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to the international duty and convenience, and to the rights of its own citizens, or of other persons who are under the protection of its laws. However, the court noted that the principles of comity do not stand for the notion that a US Court can exercise control over a foreign court. Rather, a bankruptcy court can enforce the automatic stay extraterritorially only against entities over which it has personal jurisdiction, including the MAXAM entities.

The court concluded that the US Courts for these purposes has

personal jurisdiction over the MAXAM entities. By filing the lawsuit in the Cayman Islands, the MAXAM estates attempted to interfere with the recovery of an asset of the estate, a violation of the automatic stay.

In affirming the New York Bankruptcy Court decision, the US District Court has affirmed the global reach of the automatic stay imposed by Section 362 of the US Bankruptcy Code. The Bankruptcy Court also concluded that principles of international comity did not apply to a foreign action that violated US law and sought to interfere with the exclusive jurisdiction of the US Bankruptcy Court. This Madoff ruling should not be overstated. It is important to note that recovery actions, such as preference actions, have long been viewed as a key asset of a Chapter 11 estate. The Madoff decisions indicate that US Courts will not permit a

direct challenge to its ability to protect such assets of the estate for the benefit of all creditors.

It is clear, however, that US Courts will honor the principles of comity, and defer to foreign courts in appropriate cases. For example in the *BTA Bank* case, a Chapter 15 proceeding in the Southern District of New York, the Bankruptcy Court refused to extend the automatic stay to a Swiss arbitration proceeding. While the particulars of the *BTA Bank* case are beyond the scope of this article, it is important to note that US Courts have refused to extend the automatic stay in appropriate cases. However, this Madoff case makes clear that any attempt to interfere with a preference action, in any jurisdiction, will be enjoined.

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