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In Depth: U.S. Bankruptcy Code Safe Harbors Protect Against Foreign Law Avoidance Claims under Chapter 15

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The U.S. Bankruptcy Code's safe harbor provisions provide comfort to financial institutions that transfers made under protected financial contracts will generally not be subject to avoidance or "clawback" if the transferor subsequently files for bankruptcy protection under Chapter 7 or Chapter 11 of the U.S. Bankruptcy Code. But is the same true where the transferor is a foreign debtor whose main insolvency proceeding is occurring outside the United States, and whose representatives merely petition for "recognition" of the foreign proceeding in the United States under Chapter 15 of the Code? The U.S. District Court for the Southern District of New York recently confirmed that the safe harbors provide protection under this circumstance as well, even with respect to foreign law claims based on foreign transactions. *See Fairfield Sentry Ltd. v. Citibank, N.A. London*, 2022 WL 3644436 (S.D.N.Y. Aug. 24, 2022).

Background

Fairfield involved three investment funds organized in the British Virgin Islands ("BVI") that invested in Bernard Madoff's Ponzi scheme. After Madoff's scheme collapsed, the funds became subject to insolvency proceedings in a BVI court, which appointed liquidators to recover and equitably distribute assets on behalf of the members of the funds. The liquidators, acting as the funds' "foreign representatives," obtained recognition of the BVI insolvency proceedings in the SDNY Bankruptcy Court under Chapter 15. The liquidators also initiated proceedings in the U.S. under the BVI Insolvent Act, seeking to avoid certain allegedly preferential or constructively fraudulent payments made to investors who had cashed out their investments in the funds prior to the Madoff scheme's collapse. The Bankruptcy Court ultimately dismissed these BVI law claims as barred by the Bankruptcy Code's Section 546(e) safe harbor, which generally prevents avoidance of a "settlement payment...made by or to (or for the benefit of) a... financial institution...in connection with a securities contract."

The Appeal

On appeal, the District Court affirmed the Bankruptcy Court's holding that the BVI law avoidance claims were barred by the 546(e) safe harbor.

In doing so, the District Court rejected the liquidators' argument that Section 546(e) applied only to transactions within the United States and not "extraterritorially" to foreign transactions. The Court recognized a general presumption against extraterritorial application of a statute, but held that 546(e) applied notwithstanding this presumption under a two-step analysis developed by the U.S. Supreme Court that considers (i) whether the statute gives a clear indication that it applies extraterritorially, and (ii) whether the case involves a domestic application of the statute, as determined by looking to the statute's "focus."

With respect to the first step, the Court concluded that Congress had expressed a clear intent to apply 546(e) extraterritorially through Section 561(d) of the Bankruptcy Code, which provides that under Chapter 15 the safe harbors "limit avoidance powers to the same extent as in a proceeding under chapter 7 or 11." 11 U.S.C. § 561(d). The Court reasoned that because Section 561(d) requires the safe harbors to apply under Chapter 15 "to the same extent" as under Chapter 7 or 11, and because under Chapter 7 or 11 the safe harbors would bar all preference and constructive fraudulent transfer claims with respect to protected parties and contracts, the 546(e) safe harbor must similarly bar all analogous claims in a Chapter 15 case, even if brought with respect to non-U.S. transactions and under foreign law.

With respect to the second step, the Court concluded that application of the 546(e) safe harbor was domestic rather than extraterritorial, because the "focus" of the safe harbor was ultimately to limit the foreign representatives' avoidance powers in a U.S. court.

Importantly, the Court also recognized that under Chapter 15, as under Chapters 7 and 11, the Section 546(e) safe harbor does not bar claims based on intentional, as opposed to constructive, fraud. The Court concluded, however, that the *Fairfield* liquidators had not asserted any intentional fraud claims, because their BVI law claims related only to unfair preferences and constructively fraudulent transfers. Therefore, the exception for intentional fraud did not apply in this case.

Takeaways

The *Fairfield* decision gives financial institutions increased comfort that under Chapter 15, just as under Chapters 7 and 11, the U.S. Bankruptcy Code's safe harbor provisions should render transactions under protected financial contracts immune from "clawback" based on preference or constructive fraudulent transfer claims. However, just as under Chapters 7 and 11, this Chapter 15 immunity does not extend to claims based on intentional fraud.