The long arm of the law: Avoidance actions without borders

David Conaway writes on the long reach of the US Bankruptcy Code

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A June 2018 Bankruptcy Court decision in the Southern District of New York (SDNY) held that foreign companies with no presence in the US were subject to default judgements.

Foreign-based companies doing business in the US, and foreign affiliates of US companies, are routinely counter-parties to a variety of commercial contracts in the US. Given the vicissitudes of financial and economic conditions, it is inevitable that such companies will occasionally encounter the insolvency of their counter-party. The insolvency could be pursuant to a Chapter 11 filing in the US. Increasingly, insolvencies are pursuant to foreign insolvency proceedings. Foreign insolvency proceedings may precipitate the filing of a Chapter 15 (of the US Bankruptcy Code), which is an ancillary procedure able to assist the foreign insolvency estate regarding U.S. assets, claims and related issues.

Unfortunately, Chapter 11 cases often result in the pursuit of preference claims against parties who received payments from the debtor-counterparties under such contracts prior to the Chapter 11 filing. Also, Chapter 11 estates may seek to recover payments as "fraudulent conveyances". In Chapter 15 cases, the foreign insolvency estate may not pursue avoidance actions under the US Bankruptcy Code. However, US courts have ruled that the foreign insolvency estates may recover on avoidance actions based on the laws of the foreign jurisdiction, and based on state law avoidance statutes, such as the Uniform Fraudulent Transfer Act, as adopted by US States.

> FOREIGN AFFILIATES OF US COMPANIES ARE ROUTINELY COUNTER-PARTIES TO A VARIETY OF COMMERCIAL CONTRACTS IN THE US

In the Chapter 11 case of *Advance Watch Company, Ltd.*, the Bankruptcy Court for the SDNY ruled that default judgements on preference claims against Hong Kong based companies were valid and enforceable. In *Advance Watch*, the Advance Watch trustee filed adversary proceedings in the SDNY to recover payments made to the defendants. In each of the lawsuits, the Bankruptcy Court determined that the Hong Kong companies had been properly served with process under Rule 4(f) of the Federal Rules of Civil Procedure regarding service on foreign defendants. Rule 4(f) requires compliance with The Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters (1965) (the "Hague Service Convention"). The Hague Service Convention in turn requires that service complies with the laws of Hong Kong.

The Hong Kong companies ignored the complaints. In response, the trustee filed motions for default judgements against the foreign companies. The Advance Watch Court noted that The Hague Service Convention is NOT applicable to the service of pleadings, other than the summons and complaint. Rather, FRCP 5(b)(2)(c) requires only that the motions for default be mailed

to the defendants' last known addresses. The trustee need only submit an affidavit to that effect with no requirement of proof of actual service.

As a consequence of the Court's ruling, the Hong Kong companies are now subject to the US judgements against them. Though it is not ideal to have a US judgement outstanding, it is unclear of the actual impact of the judgements against the foreign defendants. Certainly, the trustee could enforce the judgements against assets located in the US, including the attachment of funds owed to the companies by US affiliates or by third parties. Identifying assets to attach could be difficult and expensive, if the foreign entity does not maintain operations in the US.

Exporting a US judgement abroad can be nearly impossible, since the US is not a party to any bilateral or multilateral treaty among countries regarding the reciprocal enforcement of judgements. Many foreign countries perceive U.S. money judgements as excessive and generally bristle at the extraterritorial exercise of jurisdiction by US courts. However, some countries will enforce US judgements based on such countries' internal laws and international comity. In this case, the trustee would be required to initiate a lawsuit in Hong Kong seeking enforcement of the U.S. judgement. It is unlikely that a Hong Kong court would recognise a US judgement against a Hong Kong company. Moreover, it is unlikely that the trustee could initiate avoidance actions based on the US Bankruptcy Code against the companies in Hong Kong courts. Accordingly, it is possible that a foreign company and its assets outside the US are practically insulated from a US Bankruptcy Court judgement for a preference recovery.

Nevertheless, the *Advance Watch* decision illustrates the long-arm of the US Bankruptcy Code, particularly the preference recovery claims. If a foreign-based entity has or will have material assets or operations in the US, it may be advisable to defend the preference claims, particularly since such claims are usually subject to substantial defenses.

In 2017, the US's largest trading partner was the European Union at $717 billion.[1] Also in 2017, EU countries represented approximately 43% of the foreign direct investment in the US. Accordingly, EU companies are likely to face recovery claims arising from insolvency cases in the US. For example, in the cases of Madoff Investment Securities and its largest feeder fund, Fairfield Sentry, hundreds of lawsuits were filed against investors for recovery of payments, many of which were EU-based companies and banks. Understanding the "long arm of the law" will be essential to minimising risk and avoiding loss in such lawsuits. ■

Footnote:
1 2017 US Census Bureau.

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