

Second Circuit Revisits Role of International Comity Involving Foreign Proceedings

In *JPMorgan Chase Bank v. Altos Hornos de Mexico, S.A. de C.V.*, 412 F.3d 418 (2d Cir. 2005), the United States Court of Appeals for the Second Circuit reaffirmed its long-standing rule, first set forth in *Koreag, Controle et Revision S.A. v. Refco F/X Assocs. Inc.*, 961 F.2d 341, 349-50 (2d Cir. 1992), that US courts do not owe comity to foreign bankruptcy proceedings in connection with disputes regarding the ownership of a foreign debtor's US assets. In so doing, the Second Circuit took the opportunity to explore the foundations of international comity and to explain the scope of the so-called "Koreag exception" to the general rule that US courts should ordinarily decline to adjudicate creditor claims that are the subject of a foreign bankruptcy proceeding, "so long as the foreign proceedings are procedurally fair and... do not contravene the laws or the public policy of the United States." *Altos Hornos*, 412 F.3d at 424 citing *Cunard S.S. Co. Ltd. v. Salen Reefer Servs. AB*, 773 F.2d 452, 457-59 (2d Cir. 1985).

Background

The *Altos Hornos* case arose when Altos Hornos de Mexico S.A. de C.V. ("Altos Hornos") filed a Mexican bankruptcy proceeding in 1999 (the "Mexican Proceeding"). At the time the Mexican Proceeding was filed, Altos Hornos owed a syndicate of banks, led by JPMorgan, approximately \$225 million (the "Loan"). Under the terms of the documentation pertaining to the Loan, a collection account was established in the name of JPMorgan at JPMorgan, from which JPMorgan had the exclusive right to make withdrawals for the following three limited purposes (1) to reimburse itself for fees and expenses, (2) to make payments on account of the Loan, and (3) after the Loan was paid off, to deliver any surplus funds

to Altos Hornos. In separate documentation, Altos Hornos assigned its rights to receive payment from three specific customers (the "Customers") to JPMorgan for deposit into the collection account. In 1999, after Altos had filed the Mexican Proceeding, the Customers made \$4.7 million of payments into the Collection Account. JPMorgan used \$880,708 to pay legal fees, but otherwise made no payments to itself or the bank syndicate from the Collection Account.

The Mexican Proceedings

Shortly after the Mexican *suspension de pagos* ("suspension of payments" or "SOP") proceedings were commenced in May, 1999 by Altos Hornos in a Mexican civil court (the "Mexican Court"), JPMorgan appeared before the Mexican Court to have the amount of the bank consortium's claim acknowledged and to have that claim determined to be a secured claim based upon the banks' rights in the Collection Account. The Mexican Court did acknowledge the consortium's claims, but it ruled that JPMorgan and the rest of the banks were merely unsecured creditors, because the agreement whereby Altos Hornos caused the Customers to make payments directly to the collection account was an "assignment" rather than "collateral" and under Mexican law that arrangement did not qualify the banks as secured creditors. Both parties appealed: Altos Hornos from the acknowledgement of the banks' claims, and JPMorgan from the determination that it was not a secured creditor under Mexican law. Both appeals were denied by the Mexican appellate court in February, 2004, and JPMorgan appealed again to the Mexican federal court. In the meantime,¹ JPMorgan determined it would take

¹ Altos Hornos was similarly not satisfied with awaiting the outcome of the Mexican appeals. In December of 2002, Altos Hornos petitioned the Mexican Court to (1) summon JPMorgan to release the funds in the Collection Account to Altos Hornos based on the ruling on appeal that the funds in the Collection Account were not collateral for the Loan, and (2) to issue a letter rogatory to a New York court to enforce that summons. JPMorgan opposed the request based on the argument that the Mexican Court lacked jurisdiction to consider the petition. The Mexican Court deferred making a decision on the request of Altos Hornos pending a decision on the appeals and therefore did not address the issue of jurisdiction raised by JPMorgan nor the question of ownership of the assets in the Collection Account.

action in the United States. It is that litigation that ultimately came before the Second Circuit.

Commencement of the US Proceedings

In March of 2003, JPMorgan sued Altos in the United States District Court for the Southern District of New York (the “District Court”) seeking a declaration that it (and not Altos Hornos) owned the funds in the Collection Account. Altos Hornos moved to dismiss this action (the “New York Action”), arguing that principles of international comity weighed in favor of obliging the District Court to abstain from deciding the questions raised by JPMorgan and to defer to the proceedings pending in Mexico. The District Court granted the motion of Altos Hornos, finding (a) that the issue of who owns the Collection Account was implicitly raised by Altos Hornos before the Mexican Court and Mexican law does not dictate where that dispute must be decided, (b) that the choice of law and forum selection clauses in the Loan documentation (both opting for New York) “would not control where international comity warranted abstention,” and (c) that because the issue was raised before the Mexican Court and that court had jurisdiction to decide the issue, “international comity required the district court to abstain and allow the issue to be resolved in the Mexican proceedings.” The District Court dismissed the New York Action. JPMorgan appealed.

Second Circuit’s Analysis of Scope of International Comity Principles

Before considering the weaknesses of the District Court decision below, the Second Circuit spent some time exploring the origins and purpose behind international comity. It began with the decision of the United States Supreme Court in *Hilton v. Guyot*, 159 US 113, 164 (1895), in which the Supreme Court explained that international comity consists of:

the recognition which one nation allows within its territory to the legislative, executive or judicial

acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.

In analyzing the history of international comity, the Second Circuit cited a number of authorities to the effect that international comity is “‘an imperfect obligation’ that ‘cannot be reduced to any certain rule.’” 413 F.3d at 423 (citations omitted). Nevertheless, at least in the Second Circuit, where issues of international comity are implicated, a general rule has emerged that US courts should ordinarily decline to adjudicate creditor claims that are the subject of a foreign bankruptcy proceeding. This is seen as being necessary in order to facilitate the equitable and orderly distribution of the debtor’s assets among creditors holding valid claims. The Second Circuit explained that deference to the foreign court is appropriate provided the foreign proceedings are procedurally fair and “do not contravene the laws or public policy of the United States.” 412 F.3d at 424 *citing Cunard*, 773 F.2d at 457-59.

The *Koreag* Exception

Having established the general rule, the Second Circuit then turned to the “limited exception” to that rule identified in *Koreag*, 961 F.2d at 349-50. The so-called “*Koreag* Exception” provides, in essence, that where questions of ownership of an asset arise, those property interests raise threshold issues that should be determined by local law and are independent of the distributive rules that apply in foreign proceedings that should be accorded comity by US courts. In other words, where a creditor which brings an action in a US court is “not asserting rights like a creditor in a bankruptcy proceeding, but rather [is] asserting that [the debtor] did not own the disputed [asset]... [the claim of the creditor is] ‘antecedent to the distributive rules of bankruptcy administration’ and thus properly adjudicated in a US court.” *Altos Hornos*, 412 F.3d 425 *citing Koreag*, 961 F.2d at 349.

Second Circuit's Review of the District Court Decision

Although the Second Circuit ultimately affirmed² the result reached by the District Court in choosing to abstain from hearing the case brought by JPMorgan, it rejected the District Court's application of the principles of international comity and the *Koreag* exception.

In reaching its decision to abstain, the District Court relied heavily on a distinction drawn by the *Koreag* court between the language set forth in section 304(b)(2) of the Bankruptcy Code,³ which provides that a bankruptcy court may order turnover of property *belonging to a foreign debtor's estate*, and the language set forth in section 304(b)(1) of the Bankruptcy Code, which allows a US court to enjoin actions against property *involved in a foreign bankruptcy proceeding*. In *Koreag*, the Second Circuit had noted that the language in section 304(b)(1) was much broader than the language in section 304(b)(2), and, that therefore, a debtor had to establish its ownership rights more conclusively in the context of a turnover action under section 304(b)(2) than in the context of a request for injunctive relief under section 304(b)(1). See *Altos Hornos*, 412 F.3d at 425. The District Court indicated that, because standard for determining property rights was more relaxed under Section 304(b)(1), the *Koreag* exception to granting comity was only applicable to turnover requests pursuant to section 304(b)(2) of the Bankruptcy Code and was not applicable to requests for injunctive relief. The District Court then reasoned that the request of Altos Hornos to dismiss the New York Action was tantamount to an injunction, rendering the *Koreag* exception inapplicable. The Second Circuit rejected this application of *Koreag* to the dispute between

JPMorgan and Altos Hornos as presented in the New York Action. *Altos Hornos*, 412 F.3d at 425-426.

First, the Second Circuit noted that the New York Action did not involve *either* section 304(b)(1) or section 304(b)(2) of the Bankruptcy Code. *Altos Hornos*, 412 F.3d at 425. Accordingly, the District Court's reliance on the language of statutes that were inapplicable constituted error. Next, the Second Circuit noted that the request of Altos Hornos to dismiss the New York Action was not tantamount to a request for injunctive relief and that the District Court erred in equating a request for dismissal with a request for injunctive relief. *Id.* The Second Circuit also pointed out that *Koreag* did not hold that federal courts are barred from determining ownership in a section 304(b)(1) proceeding; merely that such a determination was less relevant under section 304(b)(1) because that section covers property "involved in" a foreign bankruptcy proceeding, which is not strictly limited to the debtor's estate. *Altos Hornos*, 412 F.3d at 426. In summary, the Second Circuit clarified the *Koreag* exception, stating that

Bona fide questions of property ownership—whether or not raised in a § 304(b)(2) turnover action—are antecedent to the distributive rules of bankruptcy administration because they seek to determine whether an asset is actually part of the debtor's estate, rather than deciding the entitlement of certain creditors to pieces of that estate. Property ownership questions thus precede distribution and, for the reasons stated in *Koreag*, are best resolved under local law. *Id.*

As a result, the Second Circuit reaffirmed *Koreag* and reiterated that US courts may resolve bona fide questions of property ownership arising under

2 In its decision, the Second Circuit pointed out that on January 27, 2005—that is, after the appeal before the Second Circuit was argued but before the decision was rendered—the Mexican federal court reversed the decision of the lower Mexican courts and ruled that the consortium banks were secured creditors. In footnote 1 of the opinion, the court expressed its displeasure that the banks waited nearly two months to inform the Second Circuit of that judgment. Accordingly, it denied the motion brought by JPMorgan to voluntarily dismiss its appeal.

3 11 U.S.C. § 304 has been replaced by chapter 15 of the Bankruptcy Code in connection with cases filed after October 17, 2005.

local law without deferring to a pending foreign proceeding. The trouble for JPMorgan was that the Second Circuit found that there was no *bona fide* question of property ownership and, therefore, the District Court acted properly in choosing to abstain from hearing the New York Action on the grounds of international comity.

Application of *Koreag* and *Altos Hornos* to Chapter 15

The *Altos Hornos* court explicitly noted that the drafters of section 304 of the Bankruptcy Code did not intend to overrule “well-established principles based on considerations of international comity” applicable in foreign bankruptcies. 412 F. 3d 425, n. 2 citing *Cunard*, *supra*, 773 F.2d at 456. Now that section 304 has been replaced by new chapter 15⁴ of the Bankruptcy Code, it will be left to another court to determine the scope of these well-established principles of international comity and the applicability of the *Koreag* exception in chapter 15 proceedings. While chapter 15 is a relatively new statute and its scope is unclear, certain provisions of chapter 15 would appear to limit or supersede the *Koreag* exception, as reaffirmed in *Altos Hornos*. For example, section 1525 of the Bankruptcy Code provides that “[c]onsistent with

section 1501, the court shall cooperate to the *maximum extent possible* with a foreign court or a foreign representative, either directly or through the trustee.” (Emphasis added). This broad language could be interpreted to oblige a US court handling a chapter 15 case to defer to proceedings in a foreign court, even in connection with questions regarding ownership of estate assets.

We do not believe that any limitation on the *Koreag* exception was intended by the drafters of chapter 15 despite the sweeping language in section 1525. Certainly, many provisions of chapter 15 appear to counsel great deference to foreign courts. For example, chapter 15 authorizes a US court upon “recognition” of a “foreign main proceeding,”⁵ to grant broad relief to a foreign representative (see, e.g., 11 U.S.C. §1521(a)), and to “entrust the distribution of all or part of the debtor’s assets located in the United States to the foreign representative or another person” if the court determines that “the interests of creditors in the United States are sufficiently protected” (11 U.S.C. §1521(b)). Yet, nothing in new chapter 15 would seem to require that US courts must defer to foreign courts where the antecedent question of what assets are actually owned by the debtor are at issue. The *Koreag* exception, as amplified by *Altos Hornos*, should continue to have efficacy despite the enactment of chapter 15.

4 Chapter 15 went into effect on October 17, 2005, and creates a comprehensive scheme for cross-border insolvency proceedings that replaces the “ancillary proceeding” previously available under section 304 of the Bankruptcy Code, the section of the Bankruptcy Code at issue in *Koreag*.

5 A “foreign main proceeding” is a foreign bankruptcy proceeding pending in the county where the debtor has the center of its main interests. The debtor’s representative in a foreign main proceeding has extensive rights under chapter 15, including the right to use property of a debtor’s estate within the United States as permitted by section 363 of the Bankruptcy Code.