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Second Circuit Affirms District Court's Power to Prevent Involuntary Bankruptcy Filings

In a recent decision, *SEC v. Byers*,¹ the Second Circuit Court of Appeals held that district courts possess the authority and discretion to bar the filing of involuntary bankruptcy petitions without the district court's permission. While cautioning that district courts should exercise this authority sparingly, the Second Circuit affirmed that in the context of an SEC receivership, district courts may enter anti-litigation injunctions which prevent any creditor or claimant from filing a lawsuit, lien, encumbrance, or bankruptcy case without first obtaining the district court's approval.

Then District Judge Chin imposed the anti-litigation injunction after the Securities and Exchange Commission ("SEC") filed a complaint against Stephen Byers, Joseph Shereshevsky and various Wextrust entities, alleging a massive Ponzi scheme involving 240 Wextrust affiliates across the United States, the Middle East and Africa that purportedly defrauded investors of approximately \$255 million. The same day that the SEC filed its complaint, Judge Chin appointed a temporary receiver to, among other things, investigate the financial condition of the Wextrust entities (including the extent of co-mingled funds) and to determine whether the Wextrust entities should file for bankruptcy. Along with the appointment of the receiver, the District Court also imposed an anti-litigation provision that prevented any person or entity, including any creditor or claimant against any defendant, from taking any action interfering with the "taking control, possession, or management of the assets," including filing lawsuits, liens, or encumbrances, or bankruptcy cases that would impact the property and assets of the receivership estate. It then issued a preliminary injunction including this provision with the consent of all parties. One week later, two committees of Wextrust creditors filed motions requesting that Judge Chin either delete the prohibition against involuntary bankruptcy filings or lift the anti-litigation injunction.

Judge Chin denied the creditors' motions to lift the anti-litigation injunction, finding instead that the District Court had the authority to enjoin non-parties from filing involuntary bankruptcy petitions against the Wextrust entities. Judge Chin reasoned that this authority derives from the District Court's jurisdiction over the assets, as well as from its equitable discretion. He modified the anti-litigation injunction to allow any non-party to seek the District Court's approval to file an involuntary bankruptcy petition with three days' notice and a showing that the petition is appropriate and would benefit the receivership estate. The creditors appealed to the Second Circuit.

On appeal, the creditors argued that under section 303 of the Bankruptcy Code, creditors have an absolute right to commence an involuntary bankruptcy case against a debtor. As a

¹ *SEC v. Byers*, Case No. 09-0234 (2d Cir. June 15, 2010).

result, the creditors contended, the District Court had no authority to infringe on this absolute right by issuing the anti-litigation injunction. The Second Circuit disagreed.

The Second Circuit noted that both the Ninth and Sixth Circuits have allowed similar anti-litigation injunctions, reasoning that if a district court could not control receivership assets, then a receiver would be unable to protect them. Thus, the district court may enjoin non-parties once a receiver has been appointed so long as non-parties are given notice of the injunction. Significantly, the Second Circuit expressly rejected the argument that creditors have an absolute right to file a bankruptcy petition under the Bankruptcy Code. The Second Circuit further noted that there is no question that district courts may appoint receivers as part of their broad power to remedy federal securities law violations. Thus, there is “no unwaivable right to file an involuntary bankruptcy petition, and, even if there were, the receivership accomplishes what a bankruptcy would.” The Second Circuit compared the operation of the receivership to the operation of a stay in bankruptcy, both of which preserve the estate’s assets.

An anti-litigation injunction, the Second Circuit noted, is “simply one of the tools” available to district courts to further the goals of an SEC receivership. The anti-litigation injunction should be used sparingly, but in this case, where the receiver was charged with managing hundreds of Wextrust affiliates across the US, the Middle East and Africa, the Second Circuit held it was entirely appropriate. It works to prevent small groups of creditors from forcing Wextrust entities into bankruptcy, reducing the overall assets of the receivership estate.

The Second Circuit’s holding that creditors have no absolute right to file an involuntary bankruptcy case and that such a filing may be enjoined based on equitable discretion leaves unanswered the intriguing question of whether other circumstances exist in which a district court could enjoin such a case.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any of the following:

Alan W. Kornberg (212) 373-3209 Stephen J. Shimshak (212) 373-3133
Ann K. Young (212) 373-3234

NEW YORK

1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING

Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG

12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

LONDON

Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO

Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

WASHINGTON, D.C.

2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON

500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410