Pratt's Journal of Bankruptcy Law

LEXISNEXIS® A.S. PRATT® JUNE 2016

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)
ISBN: 978-0-7698-7988-8 (eBook)
ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] Pratt's Journal of Bankruptcy Law [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 Pratt's Journal of Bankruptcy Law 349 (2014)

An A.S. Pratt® Publication

Editorial Office
630 Central Ave., New Providence, NJ 07974 (908) 464-6800
www.lexisnexis.com

MATTHEW BENDER

(2016-Pub.4789)

Editor-in-Chief, Editor & Board of Editors

PRATT'S JOURNAL OF BANKRUPTCY LAW is published eight times a year by Matthew Bender & Company, Inc.

Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz,

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Second Circuit Wyly'ing Out? Asset Freeze Order Does Not Violate the Automatic Stay

By Andriana Georgallas*

The U.S. Court of Appeals for the Second Circuit recently held that a postpetition asset freeze order did not violate the automatic stay. The author of this article discusses the decision and its implications.

Recently, in *SEC v. Miller*,[1] the U.S. Court of Appeals for the Second Circuit held, among other things, that a postpetition asset freeze order did not violate the automatic stay. Now, I know what you're thinking: "What! That's nuts!" But, read on bankruptcy folks. It is not as Wyly'd as you may think. Remember, the all-encompassing automatic stay is not without its limits.

In *Miller*, the SEC brought a civil enforcement action against Samuel Wyly and Charles Wyly, Jr. (brothers), asserting multiple claims of securities fraud. The Wyly brothers were officers, directors, and shareholders of four publicly traded corporations. In the early 1990s, the Wyly brothers transferred millions of stock options received from those corporations to offshore trusts and subsidiaries in the Isle of Man (a self-governing British Crown dependency in the Irish Sea). The trusts exercised those options and traded in the securities while the brothers failed to disclose their beneficial ownership, returning profits of more than $550 million.

After a jury found the Wyly brothers liable for multiple claims of securities fraud, the District Court for the Southern District of New York ordered payment of approximately $300 million in disgorgement. According to trial evidence, the Wylys used the trusts to trade in secret, protect their assets from creditors, and avoid taxes on profits. Moreover, some of the proceeds flowed to Wyly family members. Thereafter, the SEC requested that the district court enter a temporary asset freeze of the Wyly brothers' assets and the assets of Wyly family members, fearing the dissipation of such gains.

While the asset freeze request was pending, Samuel Wyly and the widow of Charles Wyly, Caroline Wyly (the principal heir of Charles' estate), filed for Chapter 11. The Wylys immediately argued that the SEC's request for an asset freeze was automatically stayed by operation of Section 362 of the Bankruptcy Code.

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* Andriana Georgallas is an associate in the Business Finance & Restructuring Department at Weil, Gotshal & Manges LLP representing Chapter 11 debtors and creditors in the financial services, pharmaceutical, and retail sectors. She may be reached at andriana.georgallas@weil.com.

[1] No. 14-4261-cv (2d Cir. Dec. 18, 2015).

DISTRICT COURT GRANTS ASSET FREEZE ORDER

Shortly thereafter, the district court entered an order, among other things, freezing the Wyly brothers' assets, including the assets transferred to multiple family members that were derived or received from the trusts or the brothers, subject to certain carve outs and exceptions. The district court's order provided that the freeze remain in place until the assets were scheduled and clearly under the control of the bankruptcy court. In an accompanying opinion, the district court held that, pursuant to *SEC v. Brennan*,[2] the automatic stay did *not* preclude the entry of the asset freeze order—the SEC was "acting in its police and regulatory capacity" and, thus, the automatic stay did not apply. The district court also held that the freeze was warranted because the bankruptcy court had not yet established control over the Wyly brothers' assets (which were at risk of transfer and dissipation). All of the family-member defendants (except for the widow of Charles Wyly) appealed, asserting, among other things, that the order was issued in violation of the automatic stay.

BANKRUPTCY COURT REJECTS AUTOMATIC STAY ARGUMENT

Approximately two months after the district court's accompanying opinion, the bankruptcy court rejected the Wylys' argument that the automatic stay barred the SEC's action against Caroline Wyly as a relief defendant and declined to enforce the automatic stay against the SEC. Rather, the court held that, the SEC was acting in its police and regulatory capacity in seeking the asset freeze.

SECOND CIRCUIT HOLDS ASSET FREEZE ORDER DID NOT VIOLATE AUTOMATIC STAY

The Second Circuit began its analysis with—you guessed it—Section 362. Section 362 of the Bankruptcy Code stays virtually all proceedings against a debtor, including "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."[3] However, the automatic stay does *not* extend to "the commencement or continuation of an action or proceeding by a governmental unit . . . to enforce such government unit's or organization's police and regulatory power, including the enforcement of a judgment *other than a money judgment*, obtained in an action or proceeding by the governmental unit to enforce such governmental

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[2] 230 F.3d 65 (2d Cir. 2000).

[3] 11 U.S.C. § 362(a)(3).

unit's or organization's police or regulatory power."[4] This exception is known as the "governmental unit" exception.

All parties agreed that the SEC's enforcement action against the Wyly brothers fell within the governmental unit exception. However, the Wylys argued that the case fell under an *exception* to the governmental unit exception: actions to enforce money judgments are subject to the automatic stay, even if they were otherwise pursued by a governmental unit in furtherance of the government's police or regulatory powers. Both sides relied on *Brennan*.

SEC v. Brennan

Brennan involved a defendant found liable for securities fraud in an SEC enforcement action, who subsequently filed for bankruptcy. The defendant similarly argued that the SEC action violated the automatic stay. The order at issue in *Brennan* required the defendant to repatriate to the United States assets held in offshore protection trusts and deposit them in a court registry. The Second Circuit held that the automatic stay applied, finding that the order constituted "a step 'preparatory to money collection' " and, thus, fit within the exception to the exception.

The Second Circuit held that the district court correctly applied *Brennan* to find that the asset freeze order was exempt from the automatic stay provision and fell within the governmental unit exception but not the exception to the exception—factual, procedural, and policy considerations distinguished the Wyly's case from *Brennan*.

Factual Nature of the Order

Among other things, the Second Circuit found that the Wyly order and *Brennan* order differed significantly. In *Brennan*, the court vacated an order directing the debtor to repatriate assets held abroad and deposit them in a court registry. Here, the order was "merely an asset freeze" and, among other things, neither transferred ownership nor vested control of the assets in the courts. The court explained that, although the asset freeze order temporarily burdens the use of assets—and seeks to preserve the status quo—it does not rise to the level of impermissible enforcement of a money judgment.

Procedural Posture

In *Brennan*, the court held that "the line between [unstayed] police or regulatory power on the one hand, and [stayed] enforcement of a money judgment on the other, [must] be drawn at entry of judgment." "[U]p to the moment when liability is definitively fixed by entry of judgment, the

[4] 11 U.S.C. § 362(b)(4).

government is acting in its police or regulatory capacity. . . . However, once liability is fixed and a money judgment has been entered, the government necessarily acts only to vindicate its own interest in collecting its judgment." Applying this reasoning, the court held that the asset freeze order, which was imposed before entry of a final judgment as to the Wyly brothers, differed significantly from the *Brennan* order, which arose as part of the SEC's post-judgment collection procedures. Thus, the asset freeze order did not raise the same concerns. It did not enforce a money judgment because, as of the date of issuance of the freeze order, no judgment had yet been entered.

Policy Concerns

The court found that the policy concerns underlying *Brennan* weighed against application of the automatic stay. The policies underlying the *Brennan* decision were (i) the general purpose of the automatic stay, which is "to allow the bankruptcy court to centralize all disputes concerning property of the debtor's estate so that reorganization can proceed efficiently, unimpeded by uncoordinated proceedings in other arenas," and (ii) the general purpose of the governmental unit exception, which is "to prevent a debtor from 'frustrating necessary governmental functions by seeking refuge in bankruptcy court.' "

The Second Circuit held that the asset freeze order did not compromise either of these objectives. Instead, with respect to the former policy consideration, no conflict existed between the proceedings in the district court and those in the bankruptcy court. The asset freeze order excluded assets in the bankruptcy case and was to be lifted as soon as the assets were under the bankruptcy court's control. And, tellingly, the bankruptcy court expressed its own inclination to avoid extending the automatic stay to this case. Additionally, the court held that the order was consistent with the latter policy consideration because the Wylys commenced proceedings in the bankruptcy court and invoked the automatic stay mere days after the SEC filed its motion for an asset freeze. The court stated, "The timing speaks loudly for itself."

CONCLUSION

Miller brings into focus the purpose of the almighty automatic stay—the *sine qua non* of bankruptcy—and its limits. Although it is one of the most expansive provisions of the Bankruptcy Code, *Miller* reminds us that the automatic stay does not provide carte blanche protection for debtors. Indeed, civil orders that constrain or effect assets of a debtor in some way must be analyzed beyond their title. An "asset freeze order," *Miller* teaches us, may temporarily burden the use of the debtor's assets, but certainly does not rise to the level of an impermissible enforcement of a money judgment. As practitioners, we must peel back the onion and understand the essence of such orders in advising clients. The

exception to the exception did not prevail here, but there is always next time—in another bankruptcy, with another debtor, and another civil order.