

# ALERT



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## Bankruptcy Court Denies Chapter 15 Protection for Hedge Fund

In 2005, Congress added Chapter 15 to the Bankruptcy Code to provide more effective mechanisms for the coordination and implementation of cross-border restructurings. Chapter 15 adopts the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law (“UNCITRAL”) in 1997, which developed new international standards for cross-border reorganizations.

Recently, in a case involving a Bear Stearns hedge fund domiciled in the Cayman Islands, the Bankruptcy Court for the Southern District of New York interpreted Chapter 15 in a manner that may significantly affect future insolvency proceedings involving off-shore hedge funds.<sup>1</sup> In the Bear Stearns case, the bankruptcy court refused to recognize a Cayman Islands hedge fund’s liquidation proceeding as either a “foreign main proceeding” or a “foreign non-main proceeding” because the hedge fund had few ties to the Cayman Islands. As a result, the hedge fund was not allowed to file for Chapter 15 protection in the United States and was deprived of significant protection for its U.S.-based assets.

### Introduction to Chapter 15

The purpose of Chapter 15 and UNCITRAL is to provide effective mechanisms for coordinating and implementing cross-border insolvencies. Chapter 15 has five principal objectives: (1) to promote cooperation between United States courts and U.S. parties in interest and courts and other authorities in foreign jurisdictions; (2) to establish greater legal certainty for trade and investment; (3) to provide for the fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested entities, including the debtor; (4) to afford protection and maximization of the value of the debtor’s assets; and (5) to facilitate the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

Foreign companies seeking protection under Chapter 15 must show that a foreign proceeding has been properly commenced in a jurisdiction that is the “Center of Main Interests” (“COMI”) of the company (as defined by section 1502 of the Bankruptcy Code), in which case the U.S. bankruptcy court will recognize the foreign proceeding as a “foreign main proceeding.” Additionally, a company can seek recognition of a “foreign non-main proceeding,” which is defined as a proceeding “pending in a country where the debtor has an establishment.” “Establishment” is defined by section 1502 of the Bankruptcy Code as “any place of operations where the debtor carries out a nontransitory economic activity.”

As a general matter, debtors in foreign main proceedings (where COMI is established) automatically receive significant protections and benefits under Chapter 15. In contrast, in

foreign non-main proceedings much of the relief is granted on a discretionary basis only upon request to the court. For example, under section 1520 of the Bankruptcy Code, recognition of a foreign main proceeding triggers extension of the automatic stay to U.S.-based assets and other interests. For a foreign non-main proceeding, extension of the automatic stay must be sought from, and granted by, the bankruptcy court.

### **The Bear Stearns Case**

On July 30, 2007, the Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (the "Fund") initiated wind up proceedings under Cayman Islands law and applied for the appointment of Joint Provisional Liquidators for the Fund, subject to the supervision of the Cayman Grand Court. On July 31, 2007, the Cayman Grand Court granted the petition. On that same date, the Fund filed a Chapter 15 Petition for Recognition of a Foreign Main Proceeding in the Bankruptcy Court for the Southern District of New York, and sought recognition of the Cayman Islands proceedings as either a foreign main proceeding or a foreign non-main proceeding under chapter 15.

The Fund is a Cayman Islands exempted limited liability company and, importantly, has a registered office in the Cayman Islands. The Fund also is incorporated in the Cayman Islands. The Chapter 15 petition lists a Cayman Islands address as the Fund's mailing address but states that the Fund's principal assets are located in New York City.

PFPC Inc., a Massachusetts corporation, is the administrator of the Fund. Pursuant to an administrative services agreement, PFPC serves as administrator, registrar and transfer agent and provides day-to-day administrative services to the Fund, including accounting and clerical functions. The books and records of the Fund are maintained in Delaware. Bear Stearns Asset Management Inc. ("BSAM"), a corporation formed under the laws of the state of New York, is the investment manager for the Fund. Also, all of the assets of the Fund are managed by BSAM and are located within New York.

### **The Bankruptcy Court Refuses to Recognize the Cayman Islands Proceedings**

In its petition for recognition, the Fund argued that the COMI of the fund is the Cayman Islands simply because the Fund is registered there. The Fund cited section 1516(c) of the Bankruptcy Code, which presumes that the COMI is the place of the debtor's registered office but only "[i]n the absence of evidence to the contrary." However, the Honorable Judge Burton R. Lifland considered the Fund's

recognition petition and refused to recognize the Cayman Islands proceedings.

In his opinion, Judge Lifland first observed, "recognition under section 1517 is not to be rubber stamped by the courts. This Court must make an independent determination as to whether the foreign proceeding meets the definitional requirements of sections 1502 and 1517 of the Bankruptcy Code." Judge Lifland then stated that the Fund's "own pleadings provide the evidence to establish that the Funds' COMI is in the United States, not the Cayman Islands. The bankruptcy court noted that: (1) there are no employees or managers in the Cayman Islands; (2) the investment manager for the Funds is located in New York; (3) the Massachusetts administrator is in the United States along with the Funds' books and records; (4) prior to the commencement of the Cayman Islands proceeding, all of the Fund's liquid assets were located in United States; (5) investor registries are maintained and located in the Republic of Ireland; (6) accounts receivables are located throughout Europe and the United States; and (7) counterparties to master repurchase and swap agreements are based both inside and outside the United States but none are claimed to be in the Cayman Islands. Therefore, according to Judge Lifland, the presumption that the COMI is the place of the Funds' registered offices was rebutted by strong evidence to the contrary.

Next, the bankruptcy court examined whether the Cayman Islands proceeding could be recognized as a foreign non-main proceeding. If recognition is to be accorded as a non-main proceeding, there must be an "establishment" in the Cayman Islands for the conduct of nontransitory economic activity. Upon further examination, the bankruptcy court determined that Cayman corporate law itself prohibited "exempted companies", such as the Fund, from engaging in business in the Cayman Islands except in furtherance of their business otherwise carried on outside of the Cayman Islands, and that there was scant evidence to show that the Fund conducted any business whatsoever in the Cayman Islands. Thus, the bankruptcy court denied the Fund Chapter 15 protection under the Bankruptcy Code.

On September 10, 2007, the Fund appealed the bankruptcy court's ruling.

### **Conclusion**

The *Bear Stearns* case teaches us that Chapter 15 debtors should not assume that they automatically will be granted Chapter 15 protection in the United States, even if no party objects to jurisdiction. Judge Lifland's opinion appeared to be different than that contained in a recent decision in the

SphinX Funds Chapter 15 case — another decision by the Bankruptcy Court for the Southern District of New York, which appeared to imply that a Chapter 15 petition for recognition of a foreign main proceeding would probably be approved absent objection from a party.

Commentators have suggested that liquidation proceedings in the Cayman Islands are cheaper, are less litigious, and attract less media scrutiny than proceedings in the United States. However, as a result of the *Bear Stearns* opinion, hedge funds may have to rethink their insolvency strategy and, specifically, whether it is still viable to commence a winding-up proceeding of a hedge fund with United States assets that is registered in (and no other connections to) the Cayman Islands.

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<sup>1</sup> A copy of the opinion can be downloaded from the Southern District of New York Bankruptcy Court's website, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov), located under Case No. 07-12383.

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