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Chapter 15 Denied—The Impact of 'Bear Stearns'

It is not news that hedge funds and other off-shore entities incorporate outside the United States to take advantage of favorable local laws. That is a time-tested strategy whose benefits are well-known, at least when times are good. But directors and hedge fund managers should be aware: a recent bankruptcy court decision significantly changes the landscape for off-shore companies facing solvency concerns.

That decision, involving the high-profile insolvency of a Bear Stearns-managed hedge fund that was incorporated in the Cayman Islands, is one of only a handful of cases interpreting a new chapter of the Bankruptcy Code, Chapter 15, that addresses multinational insolvencies. The core of the decision, if it stands, could have considerable impact on the reception off-shore companies find when seeking the assistance of U.S. bankruptcy courts.

Multinational Restructuring

Historically, there was no international consensus for managing cross-border restructurings, particularly where an entity was incorporated in one country but did most or all of its business in another. More recently, in the new chapter 15 of the Bankruptcy Code, Congress adopted a formalized multinational reorganization framework that is consistent with the United Nation's model code. Besides setting parameters for international comity and cooperation, chapter 15 provides a more efficient and predictable process when a debtor files a foreign insolvency proceeding and also needs limited assistance from U.S. courts.

Specifically, chapter 15 allows a designated representative (such as a liquidator or receiver) in a non-U.S. insolvency proceeding to seek U.S. recognition of that foreign proceeding as either a foreign main proceeding (meaning that the non-U.S. insolvency case was brought where the debtor's center of main interests is located) or a foreign non-main proceeding. Notably, "center of main interests" is not defined in chapter 15, though some courts have described it as being equivalent to the principal place of business.


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If a foreign proceeding is recognized as a foreign main proceeding, the debtor is automatically granted certain core U.S. bankruptcy protections like the automatic stay of actions against the debtor's assets. If the foreign proceeding was not brought in the debtor's center of main interests but rather in a country where the debtor merely has an establishment, then it is a foreign non-main proceeding, and the U.S. bankruptcy judge has discretion whether to grant U.S. bankruptcy protections.

Although it provides limited relief, chapter 15 can be very important to off-shore entities. Critically, seeking protection under this chapter allows insolvent off-shore entities to take advantage of fundamental debtor protections under U.S. bankruptcy law while reducing expense, gaining efficiency and perhaps limiting publicity in comparison to a full U.S. bankruptcy case. Also, under chapter 15, the substantive insolvency laws of a company's home jurisdiction (rather than the U.S. Bankruptcy Code) will generally govern its reorganization or liquidation. As described below, these distinctions may become important considerations and, in some situations, it will be preferable for the off-shore jurisdiction's law to control. At the same time, there may be substantial benefits in being able to take advantage of certain U.S. bankruptcy protections, particularly the automatic stay.

This is a key strength of chapter 15: a debtor can gain some of the most important benefits of U.S. bankruptcy law without triggering the substantive application of the entire Bankruptcy Code.

'Bear Stearns': Chapter 15 Denied

Until recently, cases under new chapter 15—including those involving hedge funds managed in the United States, such as SPhinX Ltd. and Amerindo Internet Growth Fund—seemed to suggest that, if no one objected, chapter 15 relief would be available to entities incorporated off-shore even though their primary business was in the United States. SPhinX, for example, involved hedge funds incorporated in the Cayman Islands that had no operations, employees, physical offices or assets in that jurisdiction; substantially all of the SPhinX funds' assets were in the United States and their corporate administration was conducted primarily in the United States by a U.S. investment manager.[1] On those facts, Bankruptcy Judge Robert D. Drain found, and the district court recently affirmed, that although SPhinX's center of main interests was outside the Cayman Islands, the court had discretion to allow chapter 15 relief due to "pragmatic considerations" because "no negative consequences would appear from recognizing the Cayman Islands proceedings as nonmain proceedings."[2]

The law in this area is developing quickly, however: less than two months after the district court's ruling in *SPhinX*, Bankruptcy Judge Burton R. Lifland's decision in *Bear Stearns* has resoundingly rejected this discretionary approach, denying chapter 15 relief to two Cayman-incorporated hedge funds managed in the United States by Bear Stearns.[3]

According to that decision, where an off-shore entity does not have a true business "establishment" in its state of incorporation but files an insolvency proceeding there, a U.S. bankruptcy court has no discretion: it may not recognize the foreign proceeding as either a "foreign main proceeding" or a "foreign non-main proceeding." The decision drew on the plain language of Bankruptcy Code §1502(5), which authorizes chapter 15 relief only if the foreign proceeding is pending where the debtor has an "establishment." The Bankruptcy Code defines this to mean "nontransitory economic activity," or, as the court characterized it, a local place of business.

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Because the Bear Stearns hedge funds had no business activity at all in the Cayman Islands beyond the minimum necessary to remain incorporated, Judge Lifland found that they had no "establishment" there and therefore the U.S. bankruptcy court was required to deny relief under chapter 15. The joint provisional liquidators for the Bear Stearns funds have filed a notice of appeal from the bankruptcy court's decision.

Restructuring Off-Shore

Assuming the *Bear Stearns* decision is upheld on appeal, where does it leave insolvent hedge funds and other off-shore entities? *Bear Stearns* offers some suggestions, including having the hedge funds file under chapter 7 or 11, that make limited use of the tools Congress provided in chapter 15. But, these strategies may not work across the board, as described below. After the *Bear Stearns* ruling, careful planning is required, ideally well before problems arise, to ensure that a company can reorganize or liquidate so as to provide the best protection to decisionmakers and all constituents.

• ***Alternate Restructuring Options.*** The mere fact that chapter 15 recognition is unavailable to an off-shore debtor does not bar it from the U.S. bankruptcy system: chapters 7 and 11 are still options for foreign entities, as long as they have a mere minimum of assets or activities in the United States. Moreover, certain provisions of chapter 15 aimed at promoting cooperation among U.S. and foreign courts still apply in cases under chapter 7 and 11.[4]

Filing full chapter 7 or 11 cases may provide certain benefits for off-shore debtors: under those chapters, the full scope of the Bankruptcy Code is available; moreover, chapter 7 and 11 cases apply to all of the debtor's assets located anywhere in the world, thus providing a broader, more powerful restructuring tool than chapter 15. There are, however, potential drawbacks including greater expense, more onerous compliance requirements, and potential changes in constituents' rights as a result of U.S. substantive law. Indeed, in the *Bear Stearns* case, the Cayman Islands liquidators have indicated in court papers that they do not intend to seek full-blown bankruptcy protection in the United States because the substantial legal costs would reduce likely recoveries to the funds' creditors. An additional drawback of chapter 7 and 11 cases is that the stated international reach of the U.S. law may not be recognized in other countries without blessing by a foreign court.

• ***Back to Ad Hoc Multinational Restructurings.*** If a debtor needs help from both U.S. and foreign courts to reorganize—where, for example, creditors in both countries are seizing assets and the foreign court will not recognize the U.S. automatic stay — there is hope even if chapter 15 is unavailable. If *Bear Stearns* is upheld on appeal, entities incorporated offshore without business operations in their home jurisdictions will likely resort to the panoply of ad hoc reorganization techniques that were the norm before chapter 15, which have included:

- bringing full reorganization proceedings in multiple countries, with formal protocols governing the relationship among the courts (e.g., *Olympia & York, Maxwell Communication, 360 Networks*);[5]
- using parallel restructuring cases where one court recognizes another as the primary forum (e.g., *Global Crossing, FLAG Telecom*);[6]
- filing parallel proceedings in multiple jurisdictions without one being recognized as the lead case (e.g., *KPNQwest*);[7]
- bringing a lead U.S. reorganization case for a multinational group, with parallel foreign proceedings brought later only as strictly necessary (e.g., *Singer*);[8] or
- combining chapter 11 in the United States with consensual out-of-court restructuring in other jurisdictions (e.g., *Solutia, DirecTV Latin America*).[9]

This is a key strength of chapter 15: a debtor can gain some of the most important benefits of U.S. bankruptcy law without triggering the substantive application of the entire Bankruptcy Code.

As a practical matter, this hodgepodge of creative tactics has been successful in most cases, but in an ad hoc approach, it is difficult for multinationals facing insolvency to predict the business impact or ultimate outcome of their own restructuring. Ironically, this is one of the principal problems chapter 15 and the U.N. model code were intended to fix.

• ***Fitting Into Chapter 15***

Although *Bear Stearns* appears to make it harder to invoke chapter 15, that ruling may be limited to its facts: even a slightly greater business presence in the country of incorporation could change the result. Therefore, as described in more detail below, directors and managers of off-shore entities should carefully consider ways their businesses could be structured to preserve the benefits of chapter 15.

Protecting Decision Makers

• ***Best Practices for Off-Shore Incorporation.*** As noted previously, chapter 15's efficiency is attractive, but in some cases it is its limited scope that is most important because, depending on the situation, differing insolvency rules may lead to starkly different results for creditors and shareholders. For example, Cayman Islands law provides for separate treatment of the assets and liabilities of distinct portfolios within one corporate entity, even in a liquidation—a result seemingly inconsistent with the U.S. absolute priority rule. Bermuda law does not recognize the U.S. concept of substantive consolidation, in which assets and liabilities of affiliated debtors may be pooled for bankruptcy purposes. And, in *Bear Stearns*, Judge Lifland noted that certain of those debtors' transactions might be subject to avoidance if U.S. law were applied. Given these kinds of differences, decision makers should deliberate carefully with advice from experienced professionals before deciding to file a U.S. chapter 7 or 11 case, knowing that the application of U.S. law might provide worse treatment for certain creditors or shareholders than in the debtor's home jurisdiction. It is easy for unhappy constituents to criticize decision makers using 20-20 hindsight, and in such cases a strong decision process can provide much-needed protection.

Ultimately, the best protection might be to avoid chapter 7 or 11 entirely, but use chapter 15 to access key U.S. bankruptcy protections to complement an insolvency proceeding in the home jurisdiction. The *Bear Stearns* ruling suggests, however, that it may not be easy to pull off this balance without advance planning.

The best practice for companies incorporated off-shore may be to arrange their business so that a U.S. chapter 15 proceeding would be available if necessary. Specifically, after *Bear Stearns*, off-shore companies would be wise to consider conducting sufficient business activity in the home jurisdiction such that there could reasonably be said to be an "establishment" for purposes of chapter 15. Relatively simple changes—keeping a physical office with an employee in the home jurisdiction, conducting board or other meetings there, and keeping books, records or investor registers there—may create an "establishment" without harming tax-exempt status or fundamentally changing operations.

No 'Safe Harbor' Yet

There is no magic bullet: this area of the law is still developing and as yet no "safe harbor" combination of local activities has emerged as a sufficient basis for invoking chapter 15. (Parties should watch with interest a recently filed hedge fund case, *In re Basis Yield Alpha Fund (Master)*, chapter 15 Case No. 07-12762 (Bankr. SDNY), in which the debtor seeks recognition of a Cayman Islands proceeding based on apparently more significant local business activities than those listed in the *Bear Stearns* opinion.) To the extent off-shore entities maintain some business activity in their home jurisdiction, however, they will better position themselves to argue that the substantive law chosen in forming the company should also apply in the event that something goes wrong.

1. *In re SPhinX, Ltd.*, 351 BR 103, 107 (Bankr. SDNY 2006), aff'd, 2007 WL 1965597 (SDNY July 3, 2007).
2. See 2007 WL 1965597 at *7 (SDNY July 3, 2007) ("Overall, it was appropriate for the Bankruptcy Court to consider the factors it considered, to retain its flexibility, and to reach a pragmatic resolution supported by the facts found.").
3. *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 2007 WL 2479483 (Bankr. SDNY Aug. 30, 2007).
4. See 11 U.S.C. §1529.
5. See *In re Olympia & York Maiden Lane Co., LLC, et al.*, Case No. 98-B-40167 (JLG) (Bankr. SDNY); *In re Maxwell Communication Corp.*, 93 F.3d 1036 (2d Cir. 1996); *In re 360 Networks (USA), Inc., et al.*, Case No. 01-B-13721 (ALG) (Bankr. SDNY).
6. See *In re Global Crossing Ltd., et al.*, Case No. 02-41088 (REG) (Bankr. SDNY); *In re FLAG Telecom Holding Limited, et al.*, Case No. 02-11732 (ALG) (Bankr. SDNY).
7. See *In re Global Telesystems, Inc.* and *In re Global Telesystems Europe B.V.*, Case No. 01-11280 (EIK) (Bankr. D. Del.).
8. *In re The Singer Company N.V., et al.*, Case Nos. 99-10578-99-10605 (BRL) (Bankr. SDNY).
9. *In re Solutia Inc., et al.*, Case No. 03-17949 (PCB) (Bankr. SDNY); *In re DirecTV Latin America, LLC*, Case No. 03-10805 (PJW) (Bankr. D. Del.).