Chapter 15 Turns One: Ironing Out the Details

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Mark G. Douglas

October 17, 2006 marked the first anniversary of the effectiveness of chapter 15 of the Bankruptcy Code as part of the comprehensive bankruptcy reforms implemented under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Governing cross-border bankruptcy and insolvency cases, chapter 15 is patterned after the Model Law on Cross-Border Insolvency (the "Model Law"), a framework of legal principles formulated by the United Nations Commission on International Trade Law ("UNCITRAL") in 1997 to deal with the rapidly expanding volume of international insolvency cases.

Long-heralded chapter 15 replaces section 304 of the Bankruptcy Code. Section 304 allowed an accredited representative of a debtor in a foreign insolvency proceeding to commence a limited "ancillary" bankruptcy case in the U.S. for the purpose of enjoining actions against the foreign debtor or its assets located in the U.S. The policy behind section 304 was to provide any assistance necessary to assure the economic and expeditious administration of foreign insolvency proceedings. Chapter 15 continues that practice, but establishes new rules and procedures applicable to transnational bankruptcy cases that will have a markedly broader impact than section 304.

Because many of the principles and concepts in chapter 15 are consistent with those that applied to ancillary bankruptcy proceedings under section 304, bankruptcy courts called upon to interpret

the provisions of chapter 15 have some degree of guidance based upon past practice. In addition, during the seven years between chapter 15's introduction as part of comprehensive bankruptcy reform in 1998 and its enactment in 2005, a considerable body of literature was created to explain how the new rules are supposed to work. Even so, it has been left to the courts to iron out many of the details.

One issue that is unclear based upon the provisions of chapter 15 — whether a bankruptcy court can recognize and provide assistance to a foreign bankruptcy case as a secondary ("nonmain") proceeding when no primary ("main") proceeding is pending — was the subject of a ruling recently handed down by a New York bankruptcy court. In *In re SPhinX, Ltd.*, the court denied a petition seeking recognition of liquidation proceedings in the Cayman Islands as foreign "main" proceedings under chapter 15, because the evidence did not support a finding that the "center of main interest" ("COMI") of the companies involved was in the Cayman Islands. However, the court stopped short of announcing that the absence of COMI in the foreign country is, in and of itself, sufficient to deny "main" proceeding status to a foreign insolvency proceeding based on the court's concerns that the liquidators' motive for seeking recognition was to gain a tactical advantage in pending litigation involving the debtors.

The Purpose of Chapter 15

Chapter 15 is unique among the chapters of the Bankruptcy Code in declaring its purpose, which is "to provide effective mechanisms for dealing with cases of cross-border insolvency" consistent with the following objectives:

- cooperation between U.S. and non-U.S. courts and related functionaries;

- greater legal certainty for trade and investment;
- fair and efficient administration of cross-border cases in a way that protects the interests of all interested parties;
- protection and maximization of the value of the debtor's assets; and
- facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

Procedure

An accredited representative of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." "Foreign proceeding" is defined as a "collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation."

Because more than one bankruptcy or insolvency proceeding may be pending against the same foreign debtor in different countries, chapter 15 contemplates recognition in the U.S. of both a "main" proceeding — a case pending in whatever country contains the debtor's COMI — and "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment" (conducts business or owns assets). The debtor's registered office or habitual residence, in the case of an individual, is presumed to be the center of the debtor's main interest. As discussed in greater detail below, the recognition of a foreign insolvency proceeding as a "main proceeding" has marked advantages over recognition as a "nonmain proceeding" —

perhaps most significantly, the triggering of the automatic stay under section 362 of the Bankruptcy Code.

If the U.S. bankruptcy court is provided with sufficient evidence (delineated in the statute) testifying to the legitimacy of a pending foreign bankruptcy proceeding (main, nonmain or both), it "shall" enter an "order of recognition."

Interim Relief

Pending its decision on recognition, the court is empowered to grant certain kinds of provisional relief. Section 1519 authorizes the court, "where relief is urgently needed to protect the assets of the debtor or the interests of the creditors," to stay any execution against the debtor's assets, entrust the administration of the debtor's assets to a foreign representative, or suspend the right to transfer, encumber or otherwise dispose of any of the debtor's assets. Any provisional relief granted pending approval of a request for recognition terminates at such time that the bankruptcy court rules on the request, unless the court expressly orders otherwise.

Broad Powers Upon Recognition

Upon recognition of a foreign "main" proceeding, certain provisions of the Bankruptcy Code automatically come into force, and others may be deployed in the bankruptcy court's discretion by way of "additional assistance" to the foreign bankruptcy case. Among these are the automatic stay (or an equivalent injunction) preventing creditor collection efforts with respect to the debtor or its assets located in the U.S. (section 362, subject to certain enumerated exceptions), the right of any entity asserting an interest in the debtor's U.S. assets to "adequate protection" of that

interest (section 361), and restrictions on the debtor's ability to use, sell or lease its U.S. property outside the ordinary course of its business (section 363).

The bankruptcy court's decision to provide "additional assistance" (*i.e.*, relief not expressly contemplated by chapter 15 or relief authorized under other U.S. laws) must be designed to reasonably assure, among other things, that (i) all stakeholders are treated fairly, (ii) U.S. creditors are not prejudiced by asserting their claims in the foreign proceeding, (iii) the debtor's assets are not preferentially or fraudulently transferred, (iv) proceeds of the debtor's assets are distributed substantially in accordance with the order prescribed by the Bankruptcy Code, and (v) if appropriate, an individual foreign debtor is given the opportunity for a fresh start.

Finally, the bankruptcy court may exercise its discretion to order any of the relief authorized by chapter 15 upon the commencement of a case or recognition of a foreign proceeding "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."

Once a foreign main proceeding is recognized by the bankruptcy court, the foreign representative is authorized to operate the debtor's business much in the same way as a chapter 11 debtor-in-possession. He can also commence a full-fledged bankruptcy case under any other chapter of the Bankruptcy Code, so long as the foreign debtor is eligible to file for bankruptcy in the U.S. and the debtor has U.S. assets.

The foreign representative in a recognized chapter 15 case is conferred with some of the powers given to a bankruptcy trustee under the Bankruptcy Code, although they do not include the ability to invalidate preferential or fraudulent asset transfers or obligations, unless a case is pending with respect to the foreign debtor under another chapter of the Bankruptcy Code. The foreign representative may also intervene in any court proceedings in the U.S. in which the foreign debtor is a party, and can sue and be sued in the U.S. on the foreign debtor's behalf.

The SPhinX Funds Chapter 15 Proceedings

SPhinX Ltd. and a series of related companies incorporated in the Cayman Islands (collectively, the "Funds") operated as off-shore hedge funds until July of 2006. Although regulated in the Cayman Islands, the Funds did not conduct any business there and had neither employees nor offices located on the islands. None of their directors resided in the Cayman Islands. Substantially all of their assets are located in accounts in the U.S. The Funds' business was conducted under a management contract with a Delaware corporation that is a chapter 11 debtor in New York. Most, if not all, of the account managers retained under the contract to provide services to the Funds did so from the U.S.

The Funds' clients were located throughout the world. One of the largest of them was Refco Capital Markets, Ltd., which, together with its affiliates (collectively, "Refco"), is also undergoing liquidation as a chapter 11 debtor in New York. On April 13, 2006, the creditors' committee of Refco sued certain of the Funds to recover an alleged preferential payment in the amount of approximately $312 million. The committee also sought to attach the Funds' U.S. assets.

The Funds and the chapter 11 trustee that succeeded Refco's committee in the litigation reached a settlement before the preference trial began. As part of the agreement, the Funds deposited a settlement payment into escrow pending approval of the settlement by the bankruptcy court overseeing Refco's chapter 11 case. In conjunction with the committee's motion seeking that approval, certain investors in the Funds objected to the settlement on the basis that it was too favorable to Refco. They also caused involuntary winding up proceedings to be commenced against two of the Funds in the Cayman Islands.

At the hearing to consider approval of the Refco settlement, the provisional liquidators appointed in the Cayman proceedings informed the bankruptcy court that they had filed chapter 15 petitions on behalf of the Funds, and requested that the settlement motion be adjourned to give them an opportunity to evaluate the terms of the settlement. The court denied the request, finding that its analysis in determining the propriety of the proposed settlement was directed toward its impact on Refco's estate and creditors, and noting that it was not the appropriate forum to resolve a dispute involving allegations that the non-debtor proponents' execution of the agreement was actionable in some way.

The bankruptcy court approved the Refco settlement on June 9, 2006. Certain Fund investors appealed that order to the district court. Under the terms of the settlement agreement, it will not become effective until the favorable resolution of any appeal of the bankruptcy court's order. Meanwhile, the Cayman Islands court overseeing the liquidation proceedings commenced on behalf of two of the Funds dismissed the cases, and the liquidators withdrew their chapter 15 petitions.

All of the Funds were put into voluntary liquidation on June 30, 2006 after certain investors assumed control of the group, and substantially all of them filed voluntary winding up petitions in the Cayman Islands court on July 4, 2006. Although the Funds' liquidators agreed shortly thereafter to prosecute the pending appeal of the Refco settlement in accordance with the district court's scheduling order, they filed chapter 15 petitions on behalf of the Funds in New York on July 31, 2006 and immediately sought to enjoin continuation of the litigation, asserting that they needed time to investigate whether the settlement was improper from the Funds' perspective. The liquidators also requested an order recognizing the Cayman Islands' insolvency proceedings as foreign "main" proceedings.

The Bankruptcy Court's Ruling

Chapter 15, the bankruptcy court explained, maintains and in some respects enhances the "maximum flexibility" that section 304 gave to courts in dealing with ancillary cases. This flexibility is evident not only in chapter 15's statement of purpose, but in provisions of the statute that permit the court to grant or modify interim relief, or to grant additional relief "only if the interests of creditors and other interested entities, including the debtor, are sufficiently protected." According to the court, flexibility is also manifested in the broad range of relief that a bankruptcy court can grant to an accredited representative of a foreign debtor, and the recognition in chapter 15 that a case under another chapter of the Bankruptcy Code may be pending concurrently with an ancillary chapter 15 proceeding, necessitating the implementation of mechanisms to coordinate all proceedings (domestic and foreign) involving the debtor. Finally, the bankruptcy court noted, the flexibility of chapter 15 is demonstrated by provisions that permit the court to condition relief or to modify relief previously granted based upon

changed circumstances. The key to harmonizing this "pervasive flexibility" with chapter 15's objective of "greater legal certainty for trade and investment," the court observed, must lie in the directive to protect the interests of all stakeholders in accordance with procedures that maximize value.

With this as a preamble, the court turned to the threshold inquiry under chapter 15 — whether the Cayman Islands' liquidation proceedings involving the Funds should be recognized as "foreign proceedings." The parties did not dispute this issue. However, Refco's chapter 11 trustee opposed recognition of the Cayman Islands' insolvency proceedings as foreign "main" proceedings because the automatic stay triggered by such recognition would arguably prevent adjudication of the appeal involving the Refco settlement.

The practical significance of affording recognition as either category of foreign proceeding may be minimal, the court explained, given its power to grant substantially the same range of relief in a "nonmain" proceeding that is available automatically or otherwise in a "main" proceeding. Even so, the court reasoned, because the Cayman liquidators acknowledged that they were seeking recognition of the liquidation proceedings as "main" proceedings so that the resulting automatic stay would give them more time to consider the propriety of the settlement, it was appropriate to examine carefully whether the Cayman proceedings qualified for "main" proceeding status.

The court determined that they did not. Under chapter 15, the court emphasized, a foreign main proceeding is defined as a proceeding pending in the country where the debtor has its COMI.

Chapter 15 creates a presumption that a debtor's COMI is located in the country in which its registered office is located. Still, that presumption can be rebutted, although the Bankruptcy Code, its legislative history and the paucity of established precedent construing chapter 15 offer little guidance concerning the kind of evidence necessary to overcome the presumption.

The court looked to recent foreign court decisions applying comparable criteria under relevant insolvency legislation (*e.g.*, the Model Law and the European Union Regulation on Insolvency Proceedings, both of which incorporate the concept of COMI), which indicate that "the center of main interests must be identified by reference to criteria that are both objective and ascertainable by third parties." According to the court, "important objective factors point to the SPhinX Funds' COMI being located outside of the Cayman Islands." Among these, the court explained, are administration of the Funds' hedge fund business and back office operations outside of the Caymans, the absence of any managers or employees in the Caymans, and the convening of all board meetings outside of the Cayman Islands.

"Pragmatic considerations affecting the Debtors' cases" also indicate a COMI outside of the Caymans, the court emphasized. With the exception of corporate minute books and other similar records, no assets belonging to the funds are located in the Caymans, and most, if not all, of the funds' creditors and investors are located outside of the Caymans, all of which means that the Cayman court would have to rely to a substantial degree on foreign courts to wind up the Funds' affairs.

These factors alone, the court observed, did not preclude recognition of the Cayman liquidation as a "main" proceeding, because the Funds' investors, who comprised the vast majority of the stakeholders in the Cayman proceedings, did not object to the chapter 15 petition seeking recognition, and the liquidators, under the supervision of the Cayman court, were the only parties ready to perform the winding up function. However, the bankruptcy court refused to recognize the Cayman proceedings as foreign "main" proceedings because the primary purpose of the chapter 15 petition was not to assist in the efficient administration of the Cayman proceedings, but to frustrate the Refco settlement by obtaining a stay of the appeal, which the court deemed "improper." According to the court, "staying the appeal would have the same effect as overturning the [Refco settlement] *without addressing or prevailing on the merits*." The liquidators' underlying strategy, the court remarked, "taints" their request for recognition as well as the investors' consent to the chapter 15 petition, "giving the clear appearance of improper forum shopping."

Having determined, however, that some kind of recognition of the Cayman proceedings is clearly warranted, the bankruptcy court proceeded to consider whether recognition of the proceedings as nonmain proceedings would somehow violate the dictates of chapter 15. The court concluded it would not. Even though no other insolvency proceedings are pending with respect to the Funds other than in the Caymans, the court explained, "it would run contrary to logic as well as [chapter 15's] plain language and purpose to force the court to recognize a foreign proceeding as a 'main' proceeding simply because it was the only proceeding currently pending." It accordingly entered an order recognizing the Cayman liquidation cases as foreign nonmain proceedings.

Outlook

Chapter 15 is still very much in its infancy, but it is maturing rapidly. Nearly 70 chapter 15 petitions were filed in U.S. bankruptcy courts by the end of the third quarter of 2006, with the Southern District of New York by far being the preferred forum (51 cases). During that same period, the courts entered 61 recognition orders. Those orders involved recognition of foreign main proceedings in all cases but those involving the 23 Sphinx-related entities.

The main versus nonmain distinction was a matter of first impression in *Sphinx*. Even so, the issue was revisited shortly afterward by a California bankruptcy court in *In re Tri-Continental Exchange Ltd.* There, the court recognized winding up proceedings commenced on behalf of three related insurance companies in St. Vincent and the Grenadines as "foreign main proceedings" under chapter 15. In doing so, it overruled a judgment creditor's contention that the winding up proceedings should be recognized only as nonmain proceedings because the debtors perpetrated insurance fraud primarily in the U.S. and Canada, and restrictions should be placed on their ability to transfer U.S. assets. The court determined that the debtors' COMI was in St. Vincent and the Grenadines because they were organized under the laws of the islands, and conducted regular business operations at their registered offices in Kingstown, St. Vincent, in a manner that equated with a "principal place of business" under concepts of U.S. law.

Sphinx and *Tri-Continental Exchange* are emblematic of the kinds of challenges facing bankruptcy courts called upon to interpret and apply the statute's as yet largely untested framework. Determining COMI is only one of many issues in chapter 15 that may prove to be

more difficult than anticipated — there are no clear guidelines governing this area in chapter 15 itself, and the body of jurisprudence construing the new law is not extensive. Although bankruptcy courts can look for guidance to rulings interpreting the Model Law and the EU Regulation on Insolvency Proceedings, both of which, as noted, incorporate COMI as a basis for a plenary bankruptcy or insolvency filing, the utility of reference is limited by the paucity of relevant decisions.

Additional guidance can be found in the Legislative Guide to the Model Law adopted by UNCITRAL on June 25, 2004 and an extensive body of legal commentary developed during the nine years since the Model Law was finalized in 1997. To date, Eritrea, Japan, Mexico, Poland, Romania, Montenegro, Serbia, South Africa, Great Britain, the British Virgin Islands, and the U.S. have enacted some version of the Model Law — Great Britain and the U.S. in the last two years. Thus, we can expect a significant proliferation in the body of caselaw interpreting COMI and many other significant concepts in chapter 15.

The pragmatic and flexible approach employed by the bankruptcy court in *Sphinx* is consistent with chapter 15's intended purpose as a vehicle for coordinating the efficient and expeditious administration of a foreign debtor's assets while safeguarding the commercial expectations of stakeholders. The decision is also a testament to the versatility of the new procedures, and the broad discretion that chapter 15 gives bankruptcy judges to fashion relief that is appropriate under the circumstances. Where, as in *Sphinx*, a bankruptcy court perceives forum shopping to be a primary motive for seeking recognition, chapter 15 gives the court sufficient discretion to

tailor relief in a way that protects the interests of stakeholders in general, but stops short of conferring an unfair advantage on any particular stakeholder.

In re SPhinX, Ltd., 2006 WL 2578727 (Bankr. S.D.N.Y. Sept. 6, 2006).

In re Tri-Continental Exchange Ltd., 349 B.R. 627 (Bankr. E.D. Cal. 2006).