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U.S. BANKRUPTCY COURT DENIES FAILED HEDGE FUNDS' REQUEST FOR CHAPTER 15 RECOGNITION

Two hedge funds affiliated with Bear Stearns & Co., Inc., the fifth-largest investment firm in the U.S., recently failed in a bid to obtain recognition under chapter 15 of the Bankruptcy Code of winding-up proceedings commenced in the Cayman Islands at the end of July for two of the firm's hedge funds that were casualties of the sub-prime mortgage meltdown. News of the filings in the Caymans led to speculation that the precedent would encourage other failed hedge funds to liquidate in the Caymans, where judges are perceived as favoring management over creditors. According to some estimates, three out of four hedge funds globally are incorporated in the western Caribbean islands. The islands of the Caribbean also are favored by special purpose vehicles that issue collateralized debt (or loan) obligations.

In a pair of decisions issued on August 30, 2007,[1] Bankruptcy Judge Burton R. Lifland denied petitions under chapter 15 of the Code for recognition in the U.S. of the pending Cayman proceedings. Although Judge Lifland's decisions do not leave the funds without recourse in attempting to prevent piecemeal dismantling of their assets, substantially all of which are (or at one time were) located in the U.S., his rulings do seriously hamper the funds' ability to coordinate those efforts under the auspices and protection of chapter 15 in the U.S. while seeking to liquidate their assets in a non-U.S. forum. The rulings suggest that U.S. bankruptcy courts interpreting newly minted chapter 15 will not rubber-stamp requests designed to take advantage of the broad range of relief available under the statute by way of assistance to qualifying bankruptcy and insolvency proceedings commenced abroad.

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1. *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (In Provisional Liquidation)*, 2007 WL 2479483 (Bankr. S.D.N.Y. Aug. 30, 2007), *as amended*, No. 07-12383 (BRL) (Bankr. S.D.N.Y. Sept. 5, 2007).

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CHAPTER 15

October 17, 2007, will mark the second anniversary of the effective date of chapter 15 of the Bankruptcy Code, enacted 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.

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.

PROCEDURE

Under chapter 15, a duly 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 "center of main interests" ("COMI")—and "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment." The debtor's registered office or habitual residence, in the case of an individual, is presumed to be a debtor's COMI, a presumption, according to the statute's legislative history, included "for speed and convenience of proof where there is no serious controversy." An "establishment" is defined by statute to be "any place of operations where the debtor carries out a nontransitory economic activity."

The Bankruptcy Code does not specify what evidence is required to rebut the presumption that COMI is the debtor's place of registration or incorporation. Various factors have been deemed relevant by courts and commentators in examining the issue, including the location of the debtor's headquarters, managers, primary assets, or creditors and which jurisdiction's law would apply to most disputes. Chapter 15 expressly directs courts to look for guidance to the interpretation of COMI by foreign jurisdictions under similar statutes, such as the EC Regulation on Insolvency Proceedings and the U.K. Enterprise Act of 2002. Additional guidance can be found in the Legislative Guide to the Model Law adopted by UNCITRAL on June 25, 2004 (the "Guide"), and an extensive body of legal commentary developed during the 10 years since the Model Law was finalized in 1997. The Guide explains that employing COMI as the basis for extending recognition for a main proceeding was modeled on the use of that concept in the EU Convention on Insolvency Proceedings. The regulation adopting the EU Convention provides that COMI is "the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." The concept is thus quite similar to the concept of "principal place of business" under U.S. law.

Chapter 15 requires that, if the U.S. bankruptcy court is provided with sufficient evidence (delineated in the statute) attesting to the legitimacy of a pending foreign bankruptcy or insolvency proceeding, it "shall" enter an "order of recognition."

INTERIM RELIEF

Pending a decision on recognition, the court is empowered to grant certain kinds of provisional relief. Chapter 15 of the Bankruptcy Code 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, while 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). In contrast, if the foreign proceeding is recognized as a "nonmain" proceeding, then the bankruptcy court *may*, but is not required to, grant a broad range of provisional and other relief designed to preserve the foreign debtor's assets or otherwise provide assistance to a main proceeding pending elsewhere.

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 FUNDS

Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., and Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd. (collectively, the "Funds"), are Cayman Islands-exempted limited liability companies with registered offices in the Cayman Islands. The Funds are open-ended investment companies that invested in a wide variety of securities, including asset-backed securities, mortgage-backed securities, derivatives, swaps, forward contracts, and futures. A Massachusetts corporation administers the Funds. The administrator served as the Funds' registrar and transfer agent and provided day-to-day administrative services. This included accounting and clerical services; processing of the issuance, transfer, and redemption of shares; shareholder, potential investor, and public relations; distributing annual reports and account statements; maintaining the Fund's principal administrative records; and paying the Funds' expenses.

The books and records of the Funds are maintained by the administrator in Delaware. Deloitte & Touche, Cayman Islands, signed off on the Funds' most recent audited financial statements. Bear Stearns Asset Management ("BSAM"), incorporated in New York, is the Funds' investment manager, and the assets managed by BSAM are located in New York. All or nearly all of the Funds' other assets (receivables from broker dealers) are also located in New York. The Funds' investor registers are maintained in Ireland by an affiliate of the administrator.

By late May of 2007, both of the Funds suffered a significant devaluation of their asset portfolios as a consequence of the well-publicized volatility in the markets triggered by the subprime mortgage meltdown. Margin calls and default notices ensued, after which many counterparties to trade agreements with the Funds exercised their rights to seize and/or sell Fund assets that had been the subject of repurchase agreements or had been pledged as collateral.

After their boards of directors authorized the Funds to file winding-up petitions under the Companies Law of the Cayman Islands, the Cayman Grand Court appointed joint

provisional liquidators of the Funds on July 31, 2007. The liquidators filed chapter 15 petitions in New York on the same day, seeking recognition of the Cayman winding-up proceedings as main proceedings and provisional relief pending the decision on recognition in the form of a temporary restraining order preventing efforts to seize the Funds' U.S. assets. Judge Lifland granted the request for emergency injunctive relief after a hearing held on August 9, 2007. Except for an ambiguous statement filed by one of the Funds' creditors requesting a determination that any finding concerning COMI should not control choice of law in actions brought by the liquidators in the U.S., no one either objected or responded to the chapter 15 petitions.

THE BANKRUPTCY COURT'S RULING

Emphasizing that recognition under chapter 15 "is not to be rubber stamped by the courts," the bankruptcy court carefully examined whether the Cayman proceedings qualified as either main or nonmain proceedings under chapter 15. It concluded that they did not.

The court acknowledged that the liquidators were accredited representatives of a debtor in a foreign bankruptcy or insolvency proceeding. Even so, the court explained, to be recognized under chapter 15, a foreign proceeding must meet the definitional requirements in the statute for either a main or a nonmain proceeding.

Based solely on the pleadings filed in support of the chapter 15 petitions, however, the court concluded that the Funds' COMI is in the U.S., not the Cayman Islands. According to the court, "[t]he only adhesive connection with the Cayman Islands that the Funds have is that they are registered there." Given the absence of anything but a tenuous connection with the Caymans, the bankruptcy court ruled that "the presumption that the COMI is the place of the Funds' registered offices has been rebutted by evidence to the contrary."

The court also denied the liquidators' alternative request for recognition of the Cayman Islands proceedings as foreign nonmain proceedings. Explaining that under Cayman Islands law, "exempted companies" are statutorily prohibited from engaging in business in the Cayman Islands except in furtherance of business carried on in other countries, the bankruptcy court ruled that the liquidators had not proved that the Funds had even an "establishment" in the Cayman Islands.

OUTLOOK

The Funds were not left without the ability to obtain relief from U.S. courts by Judge Lifland's ruling: the judge extended the temporary restraining order previously entered by an additional 30 days to give the liquidators time to decide whether or not chapter 7 or 11 cases should be commenced on behalf of the Funds. Given the location of substantially all of their assets and operations in the U.S., the Funds could likely have met the Bankruptcy Code's filing requirements for those chapters. On September 21, 2007, however, the liquidators sought yet another extension of the restraining order, contending that a chapter 7 or chapter 11 filing is not a viable option because the resulting legal costs would reduce the modest pool of funds available for distribution to creditors.

Judge Lifland's decisions are not the first rulings denying recognition under chapter 15 of a foreign main proceeding involving a Cayman Islands hedge fund. In the late summer of 2006, Bankruptcy Judge Robert D. Drain, in *In re SPhinX, Ltd.*,[2] denied a petition seeking recognition of liquidation proceedings in the Cayman Islands as foreign main proceedings because the evidence did not support a finding that the debtor-hedge funds' COMI was in the Cayman Islands, and it appeared that the liquidators' motive for seeking recognition was to gain a tactical advantage in pending litigation involving the debtors. However, the judge ruled that recognition as a foreign *nonmain* proceeding was warranted, even though the Cayman liquidation did not qualify as a main proceeding

2. *In re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), *aff'd*, 2007 WL 1965597 (S.D.N.Y. July 5, 2007).

and even though no such proceeding was pending elsewhere. In *dicta*, Judge Drain suggested that if the parties involved had not objected to the Cayman Islands proceeding being recognized as main, recognition would have been warranted solely because there were no objections and no other proceeding had been commenced elsewhere. Judge Drain's ruling was affirmed in all respects by a New York district court in July of 2007. According to Judge Lifland, the absence of any objection is largely irrelevant. The court, he remarked, "must make an independent determination as to whether the foreign proceeding meets the definitional requirements" of chapter 15.

Although varying in certain details, the message borne by these rulings is clear: U.S. bankruptcy courts are casting a critical eye on the attempts of offshore-based hedge funds to enlist the aid of chapter 15 to sort out their financial woes.

The liquidators appealed Judge Lifland's denial of their petitions for recognition on September 10, 2007. Regardless of the outcome on appeal, the rulings represent a significant step forward in the evolution and development of chapter 15 as a vehicle for coordinating cross-border bankruptcy cases.

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