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Bear Stearns Redux: Bad News For Offshore Funds

Tuesday, Jun 24, 2008 --- The failed bid of liquidators for two hedge funds affiliated with defunct investment firm Bear Stearns & Co. Inc. to obtain recognition of the funds' Cayman Islands winding-up proceedings under Chapter 15 of the Bankruptcy Code was featured prominently in business headlines during the late summer and fall of 2007.

News of the July 2007 filings fueled speculation that offshore investment funds, of which it is estimated that approximately 75% are registered in the western Caribbean, would potentially utilize Chapter 15 of the Bankruptcy Code to thwart creditor action or litigation in the U.S. while attempting to wind-up their affairs in non-U.S. jurisdictions perceived to be more management-friendly.

In a pair of decisions issued on Aug. 30, 2007 (and later amended on Sept. 5), Bankruptcy Judge Burton R. Lifland denied recognition of the Cayman proceedings as either "main" or "nonmain" foreign proceedings under Chapter 15.

In 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 S.D.N.Y. Aug. 30, 2007), amended and superseded by 374 B.R. 122 (Bankr. S.D.N.Y. 2007), Judge Lifland ruled that the funds, whose operations, assets, managers, clients and creditors were not located in the Caymans, failed to prove either that their "center of main interests" was located in the Caymans or that they even maintained an "establishment" there.

The judge did so despite the absence of any objection to the liquidators' petitions for recognition under Chapter 15. His rulings sent a clear message 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 to assist qualifying bankruptcy and insolvency proceedings commenced abroad.

The missive was decidedly unwelcome news for a great number of offshore hedge funds and other investment vehicles scrambling to sort out financial woes precipitated by the subprime mortgage crisis. Even so, trepidation in the hedge fund community over the hard line approach adopted in Bear Stearns was ameliorated somewhat by the prospect that the ruling might be overturned during the appellate process, which the liquidators began in earnest in September 2007.

The first round of the appellate process ended on May 22, 2008. In a carefully reasoned 35-page opinion parsing the language, background and objectives of Chapter 15, U.S. District Court Judge Robert W. Sweet affirmed Judge Lifland's rulings in all respects.

Thus, this round has also ended in defeat for offshore hedge funds attempting to use Chapter 15 as a means of preventing piecemeal liquidation of their U.S. assets. It remains to be seen at this juncture whether the funds' liquidators will seek further appellate review in the Second Circuit.

Chapter 15

April 17, 2008 marked the 2 1/2-year 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 replaced 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 Bankruptcy Code does not define COMI. However, Section 1516(c) provides that the debtor's registered office or habitual residence, in the case of an individual, is presumed to be the debtor's COMI. According to the statute's legislative history, this presumption was included "for speed and convenience of proof where there is no serious controversy." An "establishment" is defined to be "any place of operations where the debtor carries out a nontransitory economic activity."

In the absence of a provision in the Bankruptcy Code specifying what constitutes COMI for a corporate debtor, various factors have been deemed relevant by courts and commentators in examining COMI, including the location of the debtor's headquarters, managers, employees, investors, 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 European Union Regulation on Insolvency Proceedings (2000) and the UK Cross-Border Insolvency Regulation of 2006. 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 and in the wake of Chapter 15's enactment in 2005.

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 Regulation. The EU Regulation provides that COMI "should correspond to 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 equivalent to the "principal place of business" under U.S. law.

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) establishing the legitimacy of a pending foreign bankruptcy proceeding (main, nonmain or both), it "shall" enter an "order of recognition."

As a practical matter, recognition under Chapter 15 is a prerequisite to nearly any kind of judicial relief for a foreign debtor in the U.S.

If the court refuses to recognize a foreign proceeding under Chapter 15, it has the power to issue any appropriate order necessary to prevent the foreign representative from obtaining comity or cooperation from other U.S. courts, although the representative may still sue in U.S. courts to collect on claims belonging to the debtor and does not need bankruptcy court authority to act extra-judicially on behalf of the debtor in the U.S.

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.

Bear Stearns

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 administered 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 Aug. 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

The bankruptcy court issued its ruling on Aug. 30, 2007. Emphasizing that recognition under Chapter 15 “is not to be rubber stamped by the courts,” the 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.

The liquidators appealed the rulings to the district court on Sept. 10, 2007. Judge Lifland agreed to stay the effect of his decision pending the outcome of the appeal.

The District Court's Ruling

District Judge Sweet prefaced his discussion of the legal issues involved by remarking that "[t]he process by which the financial problems of insolvent hedge funds are resolved appears to be of transcendent importance to the investment community and perhaps even to society at large."

He also observed that, surprisingly, none of the Funds' creditors or investors appeared in the proceeding to support or challenge Judge Lifland's ruling, although several noted commentators and other parties submitted their views on the controversy as friends of the court.

Judge Sweet rejected the liquidators' contention that Chapter 15 "was enacted to foster comity" and courts should therefore apply the statute "pragmatically, based on their understanding that recognition should be withheld only in very limited circumstances."

Although relief granted upon recognition of a foreign proceeding under Chapter 15 "is largely discretionary and turns on subjective factors that embody principles of comity," the judge explained, recognition "turns on the strict application of objective criteria." Both the language of the statute and its legislative history, Judge Sweet observed, "require a factual determination with respect to recognition before principles of comity come into play."

Noting that there was no dispute concerning the factual premises underlying Judge Lifland's legal conclusions, Judge Sweet concluded that, taken as a whole, the evidence presented below did not constitute "substantive economic activity in the Cayman Islands."

According to Judge Sweet, the bankruptcy court (i) is permitted to conduct its own independent analysis of the evidence regarding COMI (notwithstanding the lack of a challenge to the Chapter 15 petition from any creditor or party in interest), (ii) correctly determined that Chapter 15's evidentiary presumption arising from incorporation had been rebutted by unchallenged facts, and (iii) properly concluded that the Funds' COMI is in New York.

The absence of any objection to recognition, he emphasized, is irrelevant:

"Appellants' emphasis on the fact that their petition was unopposed is unavailing. The lack of objection to the petition may result from any number of considerations, unknown to the courts but subject to any assumption. That absence does not relieve the bankruptcy court of its duty to apply the statute as written."

Judge Sweet also did not fault Judge Lifland's conclusion that the liquidators failed to satisfy their burden of demonstrating that the Funds had an "establishment" in the Cayman Islands, as required for recognition of a foreign nonmain proceeding under Chapter 15.

According to Judge Sweet, auditing activities and preparation of incorporation papers performed by a third party do not in plain language terms constitute "operations" or "economic activity" by the Funds.

Moreover, he emphasized, the Funds had no assets in the Cayman Islands at the time the Chapter 15 petitions were filed, a circumstance which "supports the conclusion that nonmain recognition would be inappropriate."

Finally, Judge Sweet ruled that evidence submitted by the liquidators after the bankruptcy court conducted a hearing on their recognition petitions was inadmissible, and, even if it were admissible, it would not alter his conclusions.

Outlook

Judge Sweet's ruling in Bear Stearns is bad news for offshore hedge funds that carry on a significant volume of business in the U.S. but are organized as "letter-box" companies in foreign jurisdictions.

Without the ability to obtain recognition under Chapter 15 of insolvency proceedings commenced outside of the U.S. due to the absence of any meaningful contacts with the country in question, the only recourse available to companies with tangible U.S. assets is a Chapter 7 or Chapter 11 bankruptcy filing (assuming they are otherwise eligible for relief under those chapters).

Judge Sweet's decision may not be the end of the story for the Funds – the liquidators have until the third week in June to appeal the ruling to the Second Circuit Court of Appeals. Even so, the possibility that the Court of Appeals will overturn the rulings is at best doubtful.

Bear Stearns fortifies a theme that has been recurring among U.S. bankruptcy courts called upon to apply the new statutory infrastructure regulating cross-border bankruptcy cases. In short, U.S. courts will not rubber stamp recognition requests under Chapter 15.

The ruling also illustrates an important distinction between Chapter 15 and former Section 304 ancillary proceedings.

Before the enactment of Chapter 15 in 2005, access to U.S. bankruptcy courts by an accredited representative of a foreign debtor was not dependent on recognition. Instead, the various forms of relief available under Section 304 were discretionary and based on subjective factors influenced by comity. As Bear Stearns demonstrates, that is no longer the case.

In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, 2008 WL 2198272 (S.D.N.Y. May 27, 2008).

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