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US Chapter 15 Application Refused

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In a recent decision regarding two insolvent hedge funds created by Bear Stearns, The Honourable Burton Judge Lifland sitting in the United States Bankruptcy Court, Southern District of New York refused recognition to foreign proceedings commenced in the Cayman Islands. This decision has produced a bit of clucking by the legal establishment. Perhaps they have failed to read the decision with care.

The statement of facts in *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, No. 07-12383(BRL), one of the two filed cases, is not unusual. The hedge fund manages assets in New York and maintains its books and records in Delaware, but is registered in the Cayman Islands. The company has little on the Caymans but a mailbox. The company faces financial trouble and ultimately seeks an order in the Cayman Islands that the company be wound up and a provisional liquidator appointed. The provisional liquidator wants to initiate an ancillary proceeding in the United States, and asks the US court to recognise the ongoing offshore proceedings.

In *Bear Stearns*, Judge Burton Lifland rejected the hedge funds' attempts to recognise the offshore proceedings. The court reasoned that the offshore proceedings could neither be 'foreign main proceedings', because the Cayman Islands were not the debtors' Centre of Main Interests ('COMI'), nor 'foreign non-main proceedings', because the debtors' Cayman Islands presence did not qualify as an 'establishment' under Chapter 15. As a result, the provisional liquidators could not maintain Chapter 15 proceedings in the US – despite the ongoing offshore process, and the parties' seeming consensus that Chapter 15 was an appropriate vehicle.

The court's analysis was straight-forward. Chapter 15 permits recognition of two kinds of foreign proceedings: main and non-main. If the action in the foreign jurisdiction does not fall into either of those two categories, the US court cannot recognise the foreign proceedings and commence an ancillary proceeding under Chapter 15. The *Bear Stearns* court started by examining whether the Cayman Islands action qualified as a 'foreign main proceeding'. Under 11 USC § 1502(4), a foreign main proceeding is 'a foreign proceeding pending in the country where the debtor has the centre of its main interests', or COMI. If the funds' COMI were in the Cayman Islands, the foreign insolvency case would be the main proceeding, and the US court could open an ancillary proceeding under Chapter 15.

Judge Burton Lifland gave little weight to the presumption that the debtors' registrations reflected their COMI. Under 11 USC § 1516(c), '[i]n the absence of evidence to the contrary, the debtor's registered office … is presumed to be the' COMI. The court interpreted this presumption as a weak one. Where there is evidence, the place of registration receives no particular weight. Accordingly, the court noted the variety of factors that might justify COMI status:

> 'the location of the debtor's headquarters; the location of those who actually manage the debtor (which, conceivable could be the headquarters of a holding company); the location of the debtor's primary assets; the location of the majority of the debtor's creditors or of a majority of the creditors who would be affected by the case; and/or the jurisdiction whose law would apply to most disputes.'

In this case, while the place of registration may have pointed to a COMI in the Cayman Islands, the court found that all other factors pointed to a COMI elsewhere. No party in the proceedings had challenged the petitioners' Chapter 15 petition, so the court extracted evidence from the petitioners' filings:

> '… there are no employees or managers in the Cayman Islands, the investment manager for the Funds is located in New York, the Administrator that runs the back-office operations of the Funds is in the United States along with the Funds' books and records and prior to the commencement of the Foreign Proceeding, all of the Funds' liquid assets were located in United States.'

Because nothing pointed to the Cayman Islands other than the funds' registration, the Caymans could not be the debtor's COMI and the US court could not recognise those actions in the Cayman Islands as a foreign main proceeding.

The court then considered whether it could recognise the offshore proceedings as a 'foreign nonmain proceeding', which 11 USC § 1502(5) defines to include proceedings 'pending in a country where the debtor has an establishment'. An 'establishment', in turn, is

any 'place of operations where the debtor carries out a nontransitory economic activity' (11 USC § 1502(2)). The *Bear Stearns* Court here made something of a leap, equating 'establishment' with 'a local place of business'. The new interpretation played a pivotal role in the analysis: Caymans Islands law prohibits 'exempted companies', like the hedge funds here and many other mainland entities, from engaging in any local business. The court concluded that the funds were legally barred from having an 'establishment' in the Cayman Islands. With no 'seat for local business activity', there could be no establishment, and the Caymans proceedings could not qualify as a foreign nonmain proceeding.

The Court thus denied recognition of the Caymans proceedings and ruled out any US proceedings under Chapter 15. Given Judge Lifland's stature and his involvement in the UNCITRAL Model Law on Cross-Border Insolvency and accompanying Guide to Enactment – all of which formed the basis of the US's Chapter 15 – the decision should attract significant attention. It will be interesting to see whether other courts follow the *Bear Stearns* decision. This is so for two reasons.

First, the *Bear Stearns* court rejected the Chapter 15 petition when the debtors and creditors seemed to agree that such a proceeding would best facilitate the process. No party contested the petitioners' claim of a Cayman Islands COMI. In cross-border insolvencies, it is difficult to get all interested parties into the same forum. To be sure, there may be instances when they agree on a particular forum or process for improper reasons. But there was no evidence of improper motivations in this case (other than a statement in footnote 7 that the other parties 'have their own similar relationships with offshore jurisdictions'). When all parties agree that a certain process would best facilitate a resolution, and there is no evidence that they choose that process for improper reasons, other courts may be loathe to reject the recognition opportunity.

Second, it is not clear that other courts will equate § 1502(2)'s definition of 'establishment', as a place of 'nontransitory economic activity', with the *Bear Stearns* definition, as 'a local place of business'. If courts do accept the *Bear Stearns* definition, they could well bar chapter 15 proceedings for the Islands' 'exempted companies', which are not permitted to conduct any local business. Courts may reject such a stringent interpretation. Courts may, for example, read 'nontransitory economic activity' in light of Chapter 15's purpose of providing effective mechanisms for resolving cross-border insolvencies; interpreted that way, courts may even find other economic activities – even if not purely local – sufficient economic activity to constitute an establishment and thus merit the US court's recognition of proceedings.

Yet there may be more here than meets the eye. Judge Lifland took pains to note 'there apparently exists the possibility that prepetition transactions conducted in the United States may be avoidable under U.S. Law'. If the Chapter 15 cases had proceeded the foreign representative would have had no access to the 'avoiding powers' of the Bankruptcy Code. Did the judge think that this had been the real object of the filing? Judge Lifland also noted the presence of U. S. obligors and counterparties. Was he concerned about how these players would be treated in the Caymans?

The judge took care to note that:

> 'Nonrecognition of the Foreign Proceedings, however, does not leave the Petitioners without the ability to obtain relief from U.S. courts ... Section 303(b)(4) of the Bankruptcy Code specifically provides that an insolvency case may be commenced under chapter 7 or 11 of the Bankruptcy Code by a foreign representative of the state in a foreign proceedings so that a foreign representative is not left remediless upon nonrecognition.'

If the foreign representatives follow this suggestion, the avoiding powers will be available to the foreign representatives (and if not pursued, to the creditors of the hedge funds) and US judges, lawyers and laws will protect the US parties.

Ultimately, the *Bear Stearns* court limited the availability of Chapter 15's 'ancillary' proceedings in the US based wholly on the debtor's lack of a local business in the state of the other forum. As a legal matter, the case was difficult: The *Bear Stearns* court was right not to 'rubber stamp' the parties' agreement on the proper COMI and forum, and there is yet little authority to interpret 'establishment'. The decision will have significant policy costs that other courts may find persuasive when looking at the purely legal questions, unless those other courts share Judge Lifland's subtly noted concerns.

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