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Client Alert

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Bankruptcy Court Rejects Cayman Proceedings of Bear Stearns Hedge Funds

The refusal by a U.S. Bankruptcy Judge to provide assistance to Cayman liquidation proceedings of failed Bear Stearns hedge funds raises the question of what country should conduct the bankruptcy of a hedge fund that is registered offshore but that conducts all of its business in the United States. If funds choose to file bankruptcy in their country of registration, will the United States Bankruptcy Court acquiesce and assist offshore proceedings by staying U.S. litigation and protecting U.S. assets? If the U.S. court demurs, must the funds seek protection in U.S. bankruptcy proceedings?

Recent cases answer the questions differently. The Bear Stearns decision denied the funds' petitions because the Cayman cases did not meet Chapter 15's eligibility requirements; nonetheless, it granted a 30-day stay to permit the filing of U.S. proceedings for the funds. A case involving similarly structured funds, *SPhinX*, arguably misapplied the statute by accepting the eligibility of the Cayman proceedings for U.S. assistance (and then declining to provide any).[1] Ignoring the technical distinctions, it is U.S. 2, Cayman 0.

These rulings do not suggest that Cayman registration is an unsound idea. Cayman commentators say that the "mix of regulatory, tax, speed, efficiency and cost considerations" still support Cayman as a domicile.[2] Instead, the cases reflect a U.S. legislative policy to provide the assistance of its bankruptcy courts only to those foreign bankruptcy proceedings that are premised on a tangible presence of the debtor in the foreign jurisdiction. If the debtor is really a U.S. business with only its technical domicile offshore, then the debtors' bankruptcy should be a U.S. affair.

Adopting this view, Honorable Burton R. Lifland, United States Bankruptcy Judge for the Southern District of New York (SDNY) denied the Chapter 15 petition of two Cayman-registered Bear Stearns hedge funds and found that the Cayman proceedings were not eligible for recognition and relief under Chapter 15 of the United States Bankruptcy Code (Code).[3] Chapter 15, *Ancillary and Other Cross-Border Cases*, was added to the Code in 2005 and implemented the U.S. adaptation of the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law. Goodwin Procter partner Dan Glosband was one of the principal draftsmen of both the UNCITRAL Model Law and Chapter 15.[4] Chapter 15 was designed to facilitate cooperation and coordination between U.S. bankruptcy courts and their foreign counterparts, including providing assistance to eligible foreign insolvency proceedings.

Much of Chapter 15 is structured to complement foreign proceedings and to assist foreign representatives of those foreign proceedings that meet specified definitional requirements and that take place in a country where the debtor has either its center of main interests (COMI) or a place of business operations, termed an establishment.[5] Chapter 15 establishes an objective test for recognition of a foreign proceeding and provides two alternative bases on which recognition can be granted: a foreign proceeding in the debtor's COMI will be recognized as a "foreign main proceeding" while a foreign proceeding where the debtor has an establishment will be recognized as a "foreign nonmain proceeding."[6] Relief is broader and more automatic upon recognition of a foreign main proceeding. For example the U.S. automatic stay applies and the foreign representatives are granted many of the powers of a U.S. bankruptcy trustee. If the debtor has neither its COMI nor an establishment in the country of the foreign proceeding then U.S. law should not recognize the foreign proceeding; implicitly, says the United States, the bankruptcy should be elsewhere. Judge Lifland endorsed this view of the law, relying in part on an article that Dan Glosband had written criticizing the *SPhinX* decision (discussed below).[7]

The summer 2007 financial press limned the plunge of the Bear Stearns funds into liquidation. Like a slow motion video of a diving competition, the headlines captured the fall. On June 20, 2007, the funds stepped onto the platform with "Two Big Funds At Bear Stearns Face Shutdown," a bounce followed on June 21 with "Bear Stearns Staves Off Collapse of 2 Hedge Funds," the arc down began on June 25 with "Wall Street Fears Bear Stearns Is Tip of an Iceberg" and finally the splash into the into the pool occurred on August 1 with "Bear Stearns Hedge Funds filed for Bankruptcy."[8] The bankruptcy filing was a two-step, two-country exercise: a winding up proceeding under the Cayman Companies Law in the Grand Court of the Cayman Islands accompanied by a Chapter 15 Petition for Recognition of a Foreign Proceeding.

Why the Bear Stearns funds chose the Cayman venue is not clear; perhaps the Cayman case would be cheaper without expensive U.S.-style committees; perhaps investigation or litigation involving affiliates would be less likely; perhaps the proceedings would be less transparent and attract less media coverage. Cayman lawyers say that management is not "favoured" to the detriment of creditors and investors and that Cayman courts can handle complex cross-border cases.[9] Regardless of motivation, the Bear Stearns funds filed for liquidation in the Cayman Islands and the Cayman liquidators sought to have the Cayman proceedings recognized as foreign main proceedings or, if denied, as foreign nonmain proceedings. In either case they sought injunctive protection of the funds and their U.S. assets, the right to take discovery and the turnover of U.S. assets to the Cayman liquidators.

The liquidators premised their request for recognition as foreign main proceedings on the funds' Cayman registration and domicile. Chapter 15 contains no definition of center of main interests but contains a presumption that, in the absence of evidence to the contrary, the debtor's registered office is its COMI. Judge Lifland found abundant evidence to the contrary in the funds' Chapter 15 pleadings: *"The Verified Petitions have demonstrated such evidence to the contrary: 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."

The Bear Stearns funds Chapter 15 petitions asked, in the alternative, for recognition as foreign nonmain proceedings if the Cayman proceedings were not recognized as foreign main proceedings. The same evidence proved that the Bear Stearns funds had no establishment in the Cayman Islands and, consequently, the proceedings were ineligible for recognition as foreign nonmain proceedings. The stimulus for the funds to seek "nonmain" recognition was the *SPhinX* decision, which has been criticized and which Judge Lifland rejected as incorrect. The SPhinX funds bought and sold securities in a manner that tracked a hedge fund index. While the SPhinX funds were established as Cayman Islands entities, their hedge fund business was managed by a Delaware corporation located in New York; trades were executed through Refco Capital Markets, Ltd. in New York and corporate administration (including net asset value calculation) was conducted by an unrelated entity in New Jersey. Other than gaining tax advantages from their Cayman Islands' domicile, the SPhinX funds had little to do with the Caymans: no employees, no physical offices, no directors or directors meetings, no assets, no securities or commodities trading; only minute books, statutory documents and investor documents necessary to comply with anti-money laundering requirements.

There were two attempts at Chapter 15 recognition made by two sets of Cayman liquidators of SPhinX. Both were for the clear purpose of disrupting a settlement of litigation brought against SPhinX on behalf of Refco to recover allegedly preferential payments made by Refco to SphinX. The first Cayman liquidation case was dismissed when its provisional liquidators failed to block bankruptcy court approval of the settlement. The second Cayman case and the request for Chapter 15 recognition is the subject of a reported decision by Bankruptcy Judge Robert Drain, also in the Southern District of New York. Judge Drain indicates that, but for the improper purpose of the Chapter 15 filing, he might have recognized the case as a foreign main proceeding because the funds were registered in the Caymans, they had to be wound up somewhere and no one really objected to a Cayman liquidation. However, the Court declined to designate the SPhinX Funds proceedings as foreign main proceedings because they were filed for the improper purpose of obtaining the §362 automatic stay to block an appeal of the settlement.

En route to this conclusion, the judge decided that he could initially enter an order of recognition without deciding that the proceedings were main or nonmain. This approach ignores the statute and avoids the mandatory eligibility test: does the debtor have its COMI or an establishment in the Cayman Islands? Having "recognized" the Cayman proceedings in the abstract and then declined to consider them foreign main proceedings, the Court defaulted to the position that they are foreign nonmain proceedings. He then declined to grant any relief. Ultimately, the parties were left in the same position as if recognition had been denied due to the ineligibility of the Cayman proceedings. However, the proper interpretation and application of the statute were compromised. The Bankruptcy Court's decision has

been affirmed on appeal but on a record where no party presented the eligibility issue to the appellate court.[10]

Judge Lifland acknowledged his disagreement with the *SPhinX* decisions: "*I recognize that portions of this holding are at odds with the decisions in* SPhinX*, both the bankruptcy court's decision and the district court's affirmance. However, neither of those courts addressed the 'establishment' requirement."* In his conclusion, Judge Lifland included an invitation to the parties to commence "full" U.S. proceedings under Chapter 7 or Chapter 11 and left a protective injunction in place for 30 days to permit such a filing.

The next chapter of this serial thriller may emerge from the recently filed and now pending Chapter 15 petition of the Basis Yield Alpha Fund.[11] The Basis Yield Chapter 15 petition states that the funds' administration is conducted in the Caymans but that it has over $50 million in the United States. It may be that Basis Yield actually has its COMI or an establishment in the Caymans but the record is currently incomplete. Stay tuned.

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[1] *In re: SPhinX, Ltd., et al*, Chapter 15, Case No. 06-11760 (Jointly Administered) (Bankr. S.D.N.Y. 9/6/06); affirmed 2007 WL 1965597 (S.D.N.Y. July 5, 2007).

[2] Tim Ridley, Chairman of Cayman Islands Monetary Authority, as quoted in "US Ruling Could Impact Hedge Funds" by James Dimond, cayCompass.com, 9/5/07.

[3] *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (In Provisional Liquidation)*; Case No. 07-12383; *In re Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd. (In Provisional Liquidation)*; Case No. 07-12384, Decision and Order Denying Recognition (Bankr. SDNY August 30, 2007); Amended Decision and Order Denying Recognition (Bankr. SDNY September 5, 2007)

[4] The other draftsmen of the Model Law and Chapter 15 included Professor Jay Westbrook of the University of Texas Law School and Judge Lifland.

[5] The definition of "foreign proceeding" is in §101(23), the general definition section of the Bankruptcy Code: "'foreign proceeding' means 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 the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation." The foreign representative must also be a person or body that meets the definitional requirements of §101(24): "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding."

[6] **§ 1502. Definitions**
(4) 'foreign main proceeding' means a foreign proceeding pending in the country where the debtor has the center of its main interests;
(5) 'foreign nonmain proceeding' means a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment;

[7] Daniel M. Glosband, *SPhinX Chapter 15 Opinion Misses the Mark*, 25 AM. BANKR. INST. J. 44, 45 (Dec./Jan. 2007).

[8] Headlines, respectively: 6/20/07 Wall Street Journal; 6/21/07 New York Times; 6/25/07 Wall Street Journal; 8/1/07 Associated Press.

[9] Ben Mays, Maples & Calder, and Tom Ridley quoted in Dimond article, supra.

[10] *In re SPhinX*, 2007 WL 1965597 (S.D.N.Y. July 5, 2007).

[11] *In re Basis Yield Alpha Fund*, Case # 07-12762 (Bankruptcy, S.D.N.Y.)

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