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New York District Court Refuses to Recognize Hedge Funds' Winding Up Proceedings in the Cayman Islands

In a recent decision,¹ Judge Sweet of the United States District Court for the Southern District of New York affirmed a bankruptcy court decision and refused to recognize under chapter 15 of the Bankruptcy Code either as “foreign main proceedings” or as “foreign nonmain proceedings” the well-publicized liquidations brought in the Grand Court of the Cayman Islands by two Bear Stearns hedge funds (the “Funds”). Judge Sweet’s ruling appears to close the door in the Southern District of New York – at least in the absence of a reversal on appeal by the Second Circuit Court of Appeals – on distressed hedge funds choosing offshore proceedings as the principal vehicle for their liquidation and then seeking ancillary relief under chapter 15 from a US bankruptcy court.

The District Court appeal was brought by the Joint Provisional Liquidators of the Funds (the “JPLs”) appointed by the Cayman Court. Following their appointment in July 2007, the JPLs filed uncontested petitions under chapter 15 of the Bankruptcy Code in the Bankruptcy Court for US recognition of the proceedings pending in the Cayman Court as foreign main proceedings or, in the alternative, as foreign nonmain proceedings.² Chapter 15 proceedings are ancillary to foreign proceedings. In them, foreign debtors can avail themselves of various provisions of the Bankruptcy Code, either automatically or upon request, including a stay that shields debtors and their property from creditor actions, without having to start separate U.S. plenary proceedings. Judge Lifland denied the petitions, reasoning that despite the absence of objection to the JPLs’ petitions (i) the burden of proof remained with the JPLs to show that the foreign proceeding meets the requirements of the Bankruptcy Code for recognition and (ii) the Court is required to make an independent determination whether a foreign proceeding meets such requirements. The JPLs appealed Judge Lifland’s determination to the District Court.

Judge Sweet rejected the JPLs’ main contention that Judge Lifland had ignored the long-established principles of comity and cooperation. Judge Sweet determined that both the plain language and the legislative history of chapter 15 require a factual determination that the requirements of recognition have been satisfied before principles of comity come into play.

¹ *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (In Provisional Liquidation)*, No. CIV.A.07-8730, 2008 WL 2198272; 2008 U.S. Dist. Lexis 41456 (S.D.N.Y. May 22, 2008).

² Chapter 15, which implements the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law, was added to the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8.

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Therefore, if the JPLs were not able to establish that the Cayman Islands proceedings should be recognized as either main or nonmain proceedings, then principles of comity and cooperation were not relevant.

Judge Sweet further agreed with Judge Lifland that, because each of the Fund's "center of main interests" was actually in New York, the Cayman Islands proceedings should not be recognized as main proceedings. Although Section 1516(c) of the Bankruptcy Code provides that "[i]n the absence of evidence to the contrary, the debtor's registered office [here, the Cayman Islands]. . . is presumed to be the center of the debtor's main interests," the two Funds' substantive ties with the Cayman Islands essentially ended with registration. They had no employees or managers located there. A Massachusetts corporation administered the Funds, maintaining the Funds' books and records in the administrator's Delaware office. The Funds' investment manager was located in New York, which was also the situs of the assets (at least until commencement of the Cayman Island proceedings). Receivables due to the Funds were owed by broker-dealers, virtually all of whom were in New York. Finally, the Funds maintained their investor registers in Dublin, Ireland.

The JPLs asserted that not only did the Funds have a Cayman Islands' registered office, but the Funds had substantial connections to the Cayman Islands because two directors of the Funds resided in the Cayman Islands, the Funds had pre-filing attorneys in the Cayman Islands, the Funds' auditors performed some work in the Cayman Islands, and Cayman law governed certain investments made by the Funds. Cayman Islands tax law also applied to the Funds, as did the jurisdiction's "winding up" statutes, which required the transfer of all funds to the Cayman Islands post filing. Judge Sweet found that such activities did not constitute substantive economic activity; he further concluded that the JPLs had failed to establish that the Cayman Islands directors had any substantial involvement in the Funds' business. Additionally, Judge Sweet saw no evidence that any creditor or investor of the Funds knew or had reason to know that the Funds operated as Cayman Island companies or had any location other than at Bear Stearns' New York offices.

Having declined to recognize the Cayman Islands proceedings as main proceedings, Judge Sweet next turned to whether they could qualify as nonmain. He concluded that they could not. The nonmain qualification under chapter 15 required the JPLs to establish that each of the Funds has an "establishment" in the Cayman Islands for the conduct of a "nontransitory economic activity" – in other words, a place of business in Cayman. Judge Sweet rejected the JPLs' contention that auditing activities in the Cayman Islands, preparation of incorporation papers performed by a third party in the Cayman Islands or the alleged review of insider transactions in the Cayman Islands constituted economic activity or operations. Finally, Judge Sweet noted that because chapter 15 limits the relief available in a nonmain proceeding to assets located in the nonmain jurisdiction and because the Funds had no assets in the Cayman Islands when the Cayman Islands proceedings began, nonmain recognition was not appropriate.

Given this decision, the only recourse seemingly available to the JPLs would be the filing of chapter 7 or chapter 11 petitions for the Funds – a suggestion made and later modified, by Judge Lifland. The availability of such relief is doubtful, however, because section 1511 of the Bankruptcy Code appears to limit the ability of such relief to situations in which a bankruptcy court already has entered an order granting recognition of a foreign main or nonmain proceeding. Thus, offshore funds need to evaluate carefully whether to pursue a chapter 15 strategy when a significant risk exists under *Bear Stearns* that the underlying foreign proceeding will not qualify for recognition.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any of the following:

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