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Recognition of **Foreign** Proceedings

The paradox of Chapter 15: rigid on access, flexible on relief.

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WITH the increasing number of transnational insolvencies and the need to better harmonize international insolvency regimes, Congress replaced §304 of the Bankruptcy Code with Chapter 15. While §304 had provided courts with great flexibility in managing U.S. proceedings ancillary to foreign cases, critics faulted the provision's use as unpredictable. Much seemed to depend upon the individual judge's receptivity to the petition and the requested relief. Through Chapter 15, Congress tried to rectify these problems by establishing a predictable "recognition" process and a flexible range of relief for representatives of foreign debtors.

This article discusses judicial development of Chapter 15, and the emergent themes of "rigidity" in access, yet "flexibility" in relief. Recent decisions have adopted a strict reading of the relevant statutes concerning what many thought would be a mechanical recognition process. The end result of these decisions may be the exclusion of many foreign debtors from Chapter 15. On the relief side, other rulings provide broad relief to foreign representatives, sometimes beyond the limits of domestic bankruptcy cases.

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A 'Rigid' Recognition Regime?

"Recognition" is a central concept in Chapter 15. A "foreign representative" starts a Chapter 15 case by filing a petition for recognition of a "foreign proceeding" in the Bankruptcy Court. The petition must include certain evidentiary documents, such as a certified copy of the court order commencing the foreign proceeding and appointing the foreign representative. Absent contrary evidence, the Bankruptcy Court presumes the authenticity of these documents.

Recognition typically involves classifying a foreign proceeding as "main" or "nonmain," though developing case law makes clear that a foreign proceeding may not fall into either category.[1] Upon recognition, a foreign representative automatically (in a foreign main proceeding) or upon request (in either a foreign main or nonmain proceeding) can obtain the benefit of various Bankruptcy Code provisions, including an injunction, or stay, shielding the debtor and its property from creditor actions.

In a pair of decisions that saw in Chapter 15 a "rigid" recognition procedure, two Bankruptcy Courts in the Southern District of New York refused to recognize the Cayman Islands' liquidations of some hedge funds as either foreign main or nonmain proceedings.[2]

Bear Stearns: Background

According to the uncontested facts, two Bear Stearns hedge funds sought Chapter 15 protection through Joint Provisional Liquidators, or "JPLs," appointed by the Cayman Court. The funds were exempted limited liability companies with registered offices in the Cayman Islands, but they had no employees or managers there.

The funds' administrator was a Massachusetts corporation that kept the funds' books and records at the administrator's Delaware office. A Bear Stearns entity in New York served as investment manager. The assets were also located in New York (at least until the Cayman proceedings began), including receivables owed to the funds by New York broker-dealers. The funds maintained their investor registers in Dublin, Ireland. Importantly, Bankruptcy Judge Burton R. Lifland noted that Cayman law prohibited exempted companies, like the Bear Stearns funds, from engaging in business in the Cayman Islands, except to further business elsewhere.

Basis Yield Fund: Background

In ***Basis Yield Alpha Fund (Master)***, Bankruptcy Judge Robert E. Gerber scheduled an evidentiary hearing to consider the petition filed by the Cayman Islands JPLs. He ordered the JPLs to use their "best efforts" to produce evidence establishing whether the foreign proceeding qualified for main or nonmain status. The JPLs instead filed a motion for summary judgment for recognition as a foreign main proceeding.

In his decision, Judge Gerber cited a number of uncontested facts submitted by the JPLs. Like the Bear Stearns funds, Basis Yield fund operated as a Cayman Islands registered, exempted limited liability company. Its two feeder funds, its administrator, its investment manager and its pre-filing attorneys and auditors were all domiciled in the Cayman Islands. The fund also kept its financial books and records, including its investor register, there.

Significantly, Judge Gerber found the Chapter 15 petition "strikingly silent" as to the nature or extent of Basis Yield fund's actual business activities in the Cayman Islands. His concerns included whether the fund had any employees or managers there, and whether the fund held and managed any assets in the Cayman Islands.

Legal Analysis

Although the procedural posture of the two cases differed—the Bear Stearns funds' cases involved an evidentiary hearing with

a proffer and testimony by one of the JPLs, whereas ***Basis Yield*** was decided by summary judgment—the decisions display essentially the same legal analysis. In both, the Bankruptcy Courts began by noting that the lack of opposition to the requested relief did not turn the Bankruptcy Court into a rubber stamp; it must independently determine whether a foreign proceeding met the Bankruptcy Code's recognition requirements.

A foreign "main" proceeding must be brought in the debtor's "center of main interests" or "COMI," a concept borrowed from the European Union Convention on Insolvency Proceedings. Section 1516(c) 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." Both Bankruptcy Courts found that this presumption did not shift the burden of proof away from the JPLs. Each listed typical factors relevant to the COMI analysis, including the location of the debtor's headquarters, managers, primary assets and creditors.

In ***Bear Stearns***, Judge Lifland found that the funds approximated "letterbox" companies, with registration the only significant tie to the Cayman Islands. Therefore, he ruled, the JPLs' own pleadings established that their "real seat and therefore their COMI is the United States, the place where the [Bear Stearns] Funds conduct the administration of their interests on a regular basis and is therefore ascertainable by third parties." Judge Lifland found that the COMI was in New York where the "principal interests, assets and management are located."

Having declined to recognize the Cayman Islands proceedings as main proceedings, Judge Lifland turned to whether they could qualify as nonmain. That, he said, required the JPLs to establish that each of the funds had an "establishment" in the Cayman Islands for the conduct of a "nontransitory economic activity," which he equated with "a local place of business." Given the prohibition against exempted companies conducting business in the Cayman Islands, Judge Lifland had little trouble finding that the Cayman Islands proceedings did not qualify as nonmain under Chapter 15.

In denying the Bear Stearns funds any recognition under Chapter 15, the Bankruptcy Court noted that the funds still had other remedies. Judge Lifland noted that the JPLs could file involuntary Chapter 7 or Chapter 11 petitions against the funds, citing to §303(b)(4) of the Bankruptcy Code. He kept a previously granted injunction in place for 30 days to protect the funds' assets while the JPLs considered that option. Its availability is questionable, however, since §1511 of the Bankruptcy Code appears to limit the ability of the JPLs to file such a petition to situations in which recognition as a foreign main or nonmain proceeding has already occurred.[3]

The JPLs appealed Judge Lifland's decision to the District Court. In affirming, the District Court stated that the shift from §304's subjective, comity-based recognition process to Chapter 15's more "rigid recognition standard" would promote predictability and reliability.[4] However, the District Court observed, upon recognition, a "wide range" of discretionary relief may be available to a foreign debtor based on "subjective factors that embody principles of comity."[5] Thus, the District Court saw recognition of a foreign debtor as a condition precedent to granting comity.[6]

In 'Bear Stearns' and 'Basis Yield,' the Bankruptcy Courts imposed a rigid procedural structure for recognition. With these two decisions, obtaining recognition for many foreign debtors may have gotten a lot harder.

In ***Basis Yield***, the JPLs maintained that the Bankruptcy Court must recognize the Cayman Islands proceeding as main because the JPLs had satisfied §1516(c)'s COMI presumption and no one opposed the petition.

In denying the JPLs' summary judgment motion, Judge Gerber found genuine issues of fact over the location of Basis Yield fund's COMI. While he acknowledged the COMI presumption, Judge Gerber declared that the Bankruptcy Court's independent power to examine the underlying facts of the JPLs' request (including facts not yet presented) "cannot be sidestepped or eliminated" by their decision "to not plead or introduce the relevant facts." Nor could the JPLs use the presumption "as a substitute for actual evidence" supporting recognition.

Based upon the few facts in the JPLs' petition and summary judgment motion, the Bankruptcy Court found "red flags" on the COMI question. Because Basis Yield fund, as an exempted company, had to conduct its business mainly outside of the Cayman Islands, there was "at least a question in the [Bankruptcy] Court's mind" as to whether Basis Yield fund had its COMI in the Islands. Judge Gerber also found "particularly striking" that none of the JPLs' papers meaningfully addressed the typical factors that courts use to determine foreign main proceeding status.

While noting that a Bankruptcy Court may recognize a foreign main proceeding based on the §1516 presumption, Judge Gerber rejected the contention that it must do so in the absence of an objection or fact that could put the debtor's COMI in question. "Such a result would be exactly inconsistent with one of chapter 15's expressly stated purposes, providing predictability to the financial community," he said, because it could lead to a situation where recognition depends upon whether or not parties object to a petition. The JPLs later sought and obtained the dismissal of the Chapter 15 case.

In ***Bear Stearns*** and ***Basis Yield***, the Bankruptcy Courts imposed a rigid procedural structure for recognition. To date, the vast majority of Bankruptcy Courts have relied on the presumption and not gone behind the Chapter 15 petitions in their recognition analysis. With these two decisions, obtaining recognition for many foreign debtors may have gotten a lot harder.

Flexible Relief

Upon recognition, Chapter 15 offers a range of flexible relief. The nature of that relief depends upon whether the Bankruptcy Court treats the foreign proceeding as "main" or "nonmain."

Provisional Relief Before Formal Recognition. Unlike a petition under other chapters of the Bankruptcy Code, the filing of a Chapter 15 petition does not operate as an order for relief that results in immediate relief, like the automatic stay. A Bankruptcy Court may grant provisional relief, though, until it rules on the petition.[7] It does so at the request of the foreign representative, but only "where relief is urgently needed to protect the assets of the debtor or the interests of the creditors."[8]

Upon such a finding, the Bankruptcy Court may temporarily (1) stay execution against the debtor's assets, (2) entrust the administration or realization of the debtor's assets to the foreign representative, but only for assets that are in jeopardy, and (3) grant any additional relief available to a trustee (other than avoidance powers) under the Bankruptcy Code.[9] The standards, procedures, and limitations applicable to an injunction apply to a request for provisional relief.[10] Unless extended, provisional relief terminates upon recognition of the petition.[11]

Automatic Relief Upon Recognition of a Foreign Main Proceeding. Recognition of a foreign main proceeding does trigger some immediate relief. This relief includes the automatic stay under §362 of the Bankruptcy Code, and authorization to operate the debtor's business, including the right to "use, sale or lease" of its property, just like a trustee or debtor in possession under the

Bankruptcy Code.[12]

Permissive Relief Upon Recognition of Foreign Main or Nonmain Proceeding. In either a foreign main or nonmain proceeding, a Bankruptcy Court can fashion any permitted relief necessary to effectuate Chapter 15's purpose and to protect the assets of the foreign debtor or the interests of creditors.[13] This discretionary relief is consistent with that granted to domestic debtors under the Bankruptcy Code.[14] Thus, a foreign representative may obtain any relief available to a domestic debtor in possession under the Bankruptcy Code, other than the ability to bring avoidance actions.[15]

Additional Assistance. Finally, subject to limitations found elsewhere in Chapter 15, a court may also provide "additional assistance" to a foreign representative.[16] Granting such relief requires the Bankruptcy Court to consider whether the additional assistance complies with principles of comity, as well as the former §304 factors.[17] These include:

> (1) the just treatment of all holders of claims against or interests in the debtor's property;
>
> (2) the protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;
>
> (3) the prevention of preferential or fraudulent dispositions of property of the debtor;
>
> (4) the distribution of proceeds of the debtor's property substantially in accordance with the order prescribed by this title; and
>
> (5) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.[18]

Chapter 15 Relief in Practice: How Much Flexibility? Within this statutory framework, courts have granted foreign representatives a wide range of relief under Chapter 15—both on a provisional and final basis.

As provisional relief, courts have routinely stayed parties from executing on a foreign debtor's assets in the United States.[19] Courts have also extended other Bankruptcy Code protections to foreign debtors pending a recognition decision. In ***In re MAAX Corporation, et al.***, Case No. 08-11443 (CSS) (Bankr. D. Del. 2008), a Chapter 15 case of a manufacturer and distributor of bath and spa products based in Lachine, Quebec, Canada, for example, the Bankruptcy Court entered a provisional order extending §365(e)(1) of the Bankruptcy Code, which voids so-called ipso facto clauses intended to terminate unexpired executory contracts, including leases, based on the debtor's insolvency or commencement of insolvency proceedings, to the debtors' real property leases in the Chapter 15 cases.[20]

Courts have also granted a variety of more permanent relief upon recognition of a foreign proceeding. In ***MAAX Corporation***, the Bankruptcy Court recognized the debtors' proceeding under Canada's Companies' Creditors Arrangement Act[21] as a foreign main proceeding and approved the sale of substantially all of the debtors' assets free and clear of any liens and claims under §363 of the Bankruptcy Code.[22] It also authorized the debtors' use of a centralized cash management system.[23] In another case involving a foreign main proceeding, the Bankruptcy Court allowed the debtors to obtain postpetition financing with superpriority claims and liens under §364 of the Bankruptcy Code.[24]

Representing perhaps the extreme end of flexible relief available under Chapter 15, the foreign representative in ***In re MuscleTech Ltd***. filed a Chapter 15 petition to enjoin U.S. products liability litigation against non-debtor affiliates and insiders.[25] An injunction staying litigation against non-debtor parties remains a controversial issue in Chapter 11.[26] Using Chapter 15 to enjoin U.S. tort claimants from pursuing jury trials against parties that were not even debtors in foreign proceedings based on principles developed in Chapter 11 illustrates the flexibility with which courts have approached Chapter 15 relief.

Conclusion

Congress enacted Chapter 15 as a comprehensive mechanism for managing cross-border insolvencies. Despite a statutory presumption in favor of recognition, some courts have interpreted the statute as imposing a "rigid" recognition process. Upon recognition, a foreign representative has access to a flexible range of relief that incorporates almost all, and conceivably more than all of the options available to Chapter 11 debtors under the Bankruptcy Code.

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1. ***In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (In Provision Liquidation), et al.***, 374 B.R. 122, 127 n.4 (Bankr. SDNY 2007) (Lifland, J.), aff'd, 389 B.R. 325 (SDNY 2008) [hereinafter ***Bear Stearns***]. An earlier decision, ***In re SPhinX, Ltd.***, 351 B.R. 103, 115 (Bankr. SDNY 2006) (Drain, J.), aff'd, 371 B.R. 10 (SDNY 2007), appeared to conclude that the Bankruptcy Court should place a foreign proceeding in one or the other category, to ensure some relief to the foreign representative.

2. ***Bear Stearns***, 374 B.R. at 126; ***In re Basis Yield Alpha Fund (Master)***, 381 B.R. 37, 46 (Bankr. SDNY 2008) (Gerber, J.) [hereinafter ***Basis Yield***].

3. In an amended decision, Judge Lifland acknowledged this statutory inconsistency:

> It would appear that the failure to repeal §303(b)(4) along with §304 may be a drafting error in view of the newly enacted §1511(b) which likewise addresses the commencement of a case under §§301 and 303. The inconsistencies of the two statutes have not been conformed. ***Bear Stearns***, 389 B.R. at 132 n.15.

4. Id. at 333.

5. Id.

6. Id.

7. 11 USC §1519(a).

8. 11 USC §1519(a). Notably, this means all creditors, not just those in the United States. Compare 11 USC §1519(a) (referring to "assets of the debtor or the interests of the creditors") with 11 USC §1521(b) (referring to "the interests of creditors in the United States").

9. 11 USC §§1519(a)(1) to (3); 1521(a)(7).

10. 11 USC §1519(e).

11. 11 USC §1519(b).

12. 11 USC §1520.

13. 11 USC §1521.

14. 8 COLLIER ON BANKRUPTCY (15th ed. rev. 2007), ¶ 1521.01.

15. 11 USC §1521.

16. 11 USC §1507.

17. Id.

18. 11. USC §1507(b).

19. E.g., ***In re Destinator Techs. Inc.***, Case No. 08-11003 (Bankr. D. Del. June 6, 2008); ***In re ROL Manufacturing (Canada) Ltd.***, Case No. 08-31022 (Bankr. S.D. Ohio March 7, 2008); ***In re Main Knitting Inc., et al.***, Case No. 08-11272 (Bankr. NDNY April 24, 2008).

20. ***In re MAAX Corp., et al.***, Case No. 08-11443 (CSS) (Bankr. D. Del. July 14, 2008).

21. R.S.C. 1985, c. C-36, as amended.

22. ***In re MAAX Corp., et al.***, Case No. 08-11443 (CSS) (Bankr. D. Del. Aug. 5, 2008).

23. Id.

24. ***In re ROL Manufacturing (Canada) Ltd.***, Case. No. 08-31022 (Bankr. S.D. Ohio April 17, 2008).

25. ***In re MuscleTech Research and Develop. Inc., et al.***, Case No. 06-10092 (JMP) (Bankr. SDNY Jan. 18, 2006); ***RSM Richter Inc., as Foreign Representative of MuscleTech Research and Develop. Inc. and its Subsidiaries v. Aguilar***, Adv. No. 06-1147, Case No. 06-10092 (Bankr. SDNY Jan. 18, 2008).

26. E.g., Eric W. Anderson, "Enjoining Actions Against Nondebtors: What Is the Proper Standard?" 26 AM. BANKR. INST. J. 26 (January 2008).