Recent Cross-Border Insolvency Cases and What They Mean

As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the United States Bankruptcy Code was amended and, among other things, Chapter 15 of the Bankruptcy Code was added to adopt the proposal of the United Nations Commission on International Trade Law regarding cross-border insolvency cases. Chapter 15 replaced Bankruptcy Code Section 304, which, unlike Chapter 15, focused on discretionary and subjective factors in determining whether the bankruptcy court could issue orders to assist administration of a foreign proceeding, rather than on the more simple and objective recognition standard set forth in Chapter 15, which is designed to promote comity and cooperation, as detailed below.

Three recent cases from the United States Bankruptcy Court for the Southern District of New York (two of which have been affirmed at the district court level) have limited the applicability of Chapter 15 to liquidation proceedings in the Cayman Islands for certain types of corporations, but they have not limited the ability of such corporations to seek redress in United States courts, nor have they materially affected the tax and other benefits such corporations receive under Cayman law.

I. Brief Summary of Chapter 15

With certain limited exceptions, Chapter 15 applies when a *foreign representative*[1] seeks assistance in the United States in connection with a *foreign proceeding*.[2] A case under Chapter 15 is commenced when a foreign representative files a petition for recognition of a foreign proceeding. After such a petition is filed, but prior to the entry of a recognition order, the court may grant certain provisional relief, including, among other things, staying execution against assets, suspending the ability to transfer, encumber, or dispose of assets, and providing for examinations and discovery regarding certain topics.

If a court is to recognize a foreign proceeding, it must recognize that proceeding as either a *foreign main proceeding*, if the proceeding is pending in the country where the debtor has its *center of main interests*, or as a *foreign nonmain proceeding*, if the debtor has merely an *establishment*[3] in the country where the foreign proceeding is pending. As discussed below, *center of main interests* is not defined in the Bankruptcy Code, although courts have equated it to a corporation's principal place of business and have used certain factors to determine a debtor's *center of main interests*.

Recognition of a foreign proceeding under Chapter 15 is important because, upon recognition, the foreign representative has the capacity to sue in the United States and may apply for relief directly to a United States court. If a request for recognition is denied, the court may even issue any appropriate order necessary to prevent the foreign representative from obtaining comity or cooperation from courts in the United States.

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1 A "foreign representative" means "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."

2 A "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 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."

3 "Establishment" means "any place of operations where the debtor carries out a nontransitory economic activity."

If the proceeding is recognized as a foreign main proceeding, then certain provisions of the Bankruptcy Code, such as the automatic stay, immediately apply with respect to the debtor's property within the United States, and the foreign representative can, in effect, force United States creditors to make claims in the foreign proceeding.[4] If a court recognizes a foreign proceeding as either a main proceeding or a nonmain proceeding, upon recognition, the court, subject to limited exceptions, may enter broad relief, such as staying execution, preventing the debtor's transfer of assets, or entrusting the realization or administration of the assets to a trustee or examiner.

II. Recent Southern District Decisions

In *In re Sphinx, Ltd.*,[5] *In re Bear Stearns High Grade Structure Credit Strategies Master Fund, Ltd.*,[6] and *In re Basis Yield Alpha Fund (Master)*,[7] judges in the United States Bankruptcy Court for the Southern District of New York established guidelines and limits for recognition of foreign main proceedings, even in situations where no party has objected to such recognition. It is likely that such guidelines will continue to be followed by other courts and will greatly affect the ability of hedge funds and other entities that are merely incorporated in the Cayman Islands or other foreign jurisdictions, and are liquidating in such jurisdictions, even though they have no material operations there, from obtaining recognition under Chapter 15. In each of these cases, the relevant issue was whether the liquidation proceeding pending in the Cayman Islands was a foreign main proceeding, *i.e.*, whether the Cayman Islands was the debtor's center of main interests.

Noting that center of main interests is not defined in the Bankruptcy Code, the judges considered certain factors to determine whether the Cayman Islands was the appropriate center of main interests. Specifically, they considered (i) the location of the debtor's headquarters, (ii) the location of the individuals that managed the debtor, (iii) the location of the debtor's primary assets, (iv) 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 (v) the law that would apply in most disputes.

In each case, the judges found that the petitioner had not presented sufficient evidence to support recognition as a foreign main proceeding.[8] For tax and other reasons, the funds in each of the cases had incorporated in the Cayman Islands as exempt corporations, but in general, the funds' employees, assets, headquarters, creditors, and other indicators of where they were actually conducting business were located elsewhere (typically in the United States or Europe). Indeed, as exempted corporations, they were not permitted to trade or do business with any person, firm, or corporation located in the Cayman Islands, and their business had to be conducted outside of the Cayman Islands.

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4 Specifically, Bankruptcy Code section 1520(a) provides, in pertinent part, that (a) the automatic stay and the requirement to provide adequate protection apply for property within the United States, (b) provisions related to post-petition transfers are applicable, and (c) the foreign representative may operate the business in the ordinary course subject to the limitations of Bankruptcy Code section 363.

5 351 B.R. 103 (Bankr. S.D.N.Y. 2007) (Drain, J.) *aff'd* 371 B.R. 10 (S.D.N.Y. 2007) (Sweet, D.J.).

6 374 B.R. 122 (Bankr. S.D.N.Y. 2007) (Lifland, J.) *aff'd* 2008 U.S. Dist. LEXIS 41456 (S.D.N.Y. May 22, 2008) (Sweet, D.J.).

7 381 B.R. 37 (Bankr. S.D.N.Y. 2008) (Gerber, J.).

8 The *Basis Yield Alpha Fund* case was a denial of a summary judgment motion, while the *Sphinx* and the *Bear Stearns* decisions were denials of recognition after trial. In the *Sphinx* case, the Bankruptcy Court found that recognition as a foreign nonmain proceeding was appropriate.

Importantly, in *Basis Yield Alpha Fund*, where no objections to recognition were filed, the judge noted that he would not "rubber stamp" recognition decisions and would need to make an independent inquiry regardless of whether other interested parties supported recognition. The judge in *Bear Stearns* undertook a similar independent analysis.[9] Thus, judges have indicated (or implied) their belief that courts should not just rely on presumptions in the Bankruptcy Code or the lack of objections in considering petitions for recognition, but rather, they should make independent inquiries regarding such decisions.

II. Conclusion

Simply put, these recent decisions, which have been criticized in the United States and abroad, as ignoring the purpose of Chapter 15 (and the United Nations Commission on International Trade Law), increasing the likelihood of inconsistent rulings, and potentially causing disputes over choice of law, hold that to be recognized as a foreign main proceeding, and to receive the benefits set forth in Chapter 15 of the Bankruptcy Code related to such recognition while avoiding the cost, loss of control, and oversight inherent in Chapter 11, the foreign entity must be engaged in an insolvency or liquidation proceeding in the jurisdiction that is its center of main interests (or in more familiar parlance, its principal place of business). It is clear that if funds incorporated in places where they do little or no business need to wind-down and choose to do so via the appointment of a liquidator (or similar entity) under the law of their place of incorporation, then a United States bankruptcy court will likely not recognize such foreign proceedings as main proceedings.

Absent subsequent legislative changes to Chapter 15, the bankruptcy implications of these cases are substantial – no automatic stay, no restrictions on use of assets, and no automatic ability to sue in United States courts – but the effects are not immediately devastating and can be mitigated, as foreign representatives can simply file for liquidation (or other similar foreign insolvency) in the jurisdiction that is their center of main interests, file a proceeding (if possible) under Chapter 7 or 11 in the United States and accept the reality of increased costs and oversight from certain entities, including a creditors' committee and the court, or sue in an appropriate court to seek collection on a debt or to undo a fraudulent or similar transaction. It appears unlikely that, in response to these cases, funds that have incorporated in the Cayman Islands or other foreign jurisdictions would want to incorporate elsewhere, but it is possible that such funds may want to seek to liquidate elsewhere or to commence recovery actions in the United States, whether in connection with an actual bankruptcy filing or, less likely, in connection with an action commenced in state court.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Joel Levitin at 212.701.3770 or jlevitin@cahill.com; Richard Stieglitz Jr. at 212.701.3393 or rstieglitz@cahill.com.

[9] In contrast, the judge in *Sphinx* stated in dicta that he would have considered approving main recognition if no parties had objected.