



Fund Liquidations

Cayman Islands Liquidations of Failed Bear Stearns Hedge Funds Denied Access to US Bankruptcy Court

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By HFLR Editor, *Hedge Fund Law Report*

In an opinion filed on May 27, 2008, Judge Sweet of the US District Court for the Southern District of New York affirmed a Bankruptcy Court decision holding that the official Cayman Islands liquidations of two failed Bear Stearns hedge funds were not entitled to recognition by the US Bankruptcy Court as either “main” or “nonmain” proceedings under Chapter 15 of the Bankruptcy Code. See *In re: High-Grade Structured Credit Strategies Master Fund Ltd.*, No. 07-CV-08730 (S.D.N.Y. May 27, 2008); for prior history see also *In re: Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*; *In re: Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*, 374 B.R. 122, Nos. 07-CV-12383, 12384 (Bankr. S.D.N.Y. 2007). In practice, the decision means that the joint official liquidators of the Bear funds will not be able to access the US bankruptcy system to protect the US-based assets of the failed hedge funds - or whatever remains of those US-based assets - from actions by creditors or investors.

The District Court’s decision was based largely on the Bankruptcy Court’s finding that the Cayman Islands was neither the hedge funds’ “center of main interests” nor a place where the funds carried out “nontransitory economic activity.” Implicitly, the District Court noted, its decision suggests that the debtor funds’ liquidations or reorganizations should be taking place in a jurisdiction other than the Cayman Islands, and thus the Cayman proceedings are not “entitled to assistance from the United States.”

Background

The debtor funds are the Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (High-Grade Fund) and the Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd. (Enhanced Fund, and, together with the High-Grade Fund, the Funds). In or around May 2007, based largely on investments in CDOs that included subprime mortgages, the Funds experienced precipitous declines in net asset value, margin calls from creditors and counterparties and accelerating investor redemptions. The Funds’ boards of directors filed winding-up petitions in the Cayman Islands, and on July 31, 2007, the Cayman court appointed two representatives from KPMG as the Funds’ joint provisional liquidators. On September 14, 2007, the Cayman court converted the proceeding to an official liquidation under the Cayman Islands Companies Law (2007 Revision), and the joint provisional liquidators became joint official liquidators of the Funds.

On the same day that the liquidators initiated the winding-up proceedings in the Cayman Islands, they also filed petitions in the US Bankruptcy Court for the Southern District of New York seeking recognition of the Cayman proceedings as foreign main or nonmain proceedings under Chapter 15 of the Bankruptcy Code. (The terms “main” and “nonmain” are explained more fully below.) The liquidators also sought a preliminary injunction to stay all actions in the US pending resolution of their petition for recognition.

On August 9, 2007, the Bankruptcy Court granted the preliminary injunction, and on September 5, 2007, it denied recognition of the Cayman proceedings as main or nonmain proceedings. The liquidators appealed, and on September 27, 2007, the Bankruptcy Court entered an order continuing the preliminary injunction pending final disposition of the appeal, but conditioning continuation of the injunction on the maintenance of \$4 million in US bank accounts established for each debtor Fund.

Chapter 15

As explained by the District Court, Congress added Chapter 15 to the Bankruptcy Code in 2005 to clarify the circumstances in which a liquidation or reorganization commenced in a non-US jurisdiction may be eligible for recognition by the US Bankruptcy Court. For a foreign debtor with assets in the US, such recognition is a prerequisite for assistance by the US Bankruptcy Court. Probably the most salient embodiment of such assistance is an automatic or discretionary stay imposed by the bankruptcy court on actions by creditors relating to US-based assets of a non-US debtor.

Accordingly, the typical purpose of a Chapter 15 petition is to enable a non-US liquidator - as opposed to the US courts - to control the distribution of a non-US debtor’s US-based assets.

Notably, Chapter 15 replaced Bankruptcy Code Section 304 as the statute governing access to the US courts by non-US representatives, representing a policy switch from a subjective to an objective standard. As the District Court explained, “all relief under Section 304 was discretionary and based on subjective, comity-influenced factors,” while Chapter 15 “promotes predictability and reliability . . . [b]y establishing a simple, objective eligibility requirement for recognition”

Main and Nonmain Proceedings

Under Chapter 15, a non-US proceeding can be recognized - and thus become eligible for bankruptcy court assistance - as either a “foreign main proceeding” or a “foreign nonmain proceeding.” Section 1517 of the Bankruptcy Code defines a foreign main proceeding as a proceeding pending in the country where the debtor has the “center of its main interests” (COMI), and defines a foreign nonmain proceeding as a proceeding, other than a foreign main proceeding, pending in a country where the debtor has an “establishment.” Section 1502(2) of the Bankruptcy Code defines an “establishment” as any place of operations where the debtor carries out a “nontransitory economic activity.”

If the bankruptcy court determines that the jurisdiction of the non-US proceeding is the debtor’s COMI, then the proceeding constitutes a foreign main proceeding and, under Bankruptcy Code Section 1520, certain statutory protections are automatically triggered, notably including the automatic stay under Bankruptcy Code Section 362. If the bankruptcy court determines that the jurisdiction of the non-US proceeding is not the debtor’s COMI, but that the debtor carries out

nontransitory economic activity in the jurisdiction, then the proceeding constitutes a foreign nonmain proceeding and, under Bankruptcy Code Section 1521, the court may grant “any appropriate relief,” so long as the debtor’s foreign representative can demonstrate that such relief “is necessary to effectuate the purpose of [Chapter 15].” If the bankruptcy court determines that the jurisdiction of the non-US proceeding is not the debtor’s COMI and that the debtor does not carry out nontransitory economic activity in the jurisdiction, then the bankruptcy court is required, under Chapter 15, to deny recognition to the non-US proceeding.

Analysis

Section 1506 of the Bankruptcy Code establishes what the District Court called a “rebuttable evidentiary presumption” that the state or country of the debtor’s registered office (i.e., where the debtor is incorporated) is its COMI. The court stated that COMI “means the place where the debtor conducts the administration of his interests on a regular basis” and noted that COMI has more or less the same meaning as “principal place of business” under US law. According to the court, the Bankruptcy Code does not state the type of evidence relevant to the COMI determination. Rather, factors to be considered are the product of caselaw, in particular, of *In re: SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), and include the following:

- location of the debtor’s headquarters;
- location of those who actually manage the debtor;
- location of the debtor’s primary assets;
- location of the majority of the debtor’s creditors or a majority of the creditors who would be affected by the case; and
- jurisdiction whose law would apply to most disputes.

Cayman Islands Not the Funds’ COMI

Applying certain of the *SPhinX* factors and similar factors, the Bankruptcy Court found, and the District Court agreed, that New York was the Funds’ COMI. Specifically, the courts found the following facts relevant to the COMI determination:

- the Funds had no employees or managers in the Cayman Islands;
- the Funds’ investment manager was located in New York;
- the administrator that ran the Funds’ back office operations was in the US;
- the Funds’ books and records were located in the US;
- prior to the commencement of the Cayman proceeding, all of the Funds’ liquid assets were located in the US;
- although two of the three investors in the High-Grade Fund were also companies registered in the Caymans - both of the Funds were master funds in master-feeder structures, and all of the investors in both funds were feeder funds - those companies had the same “minimum Cayman Islands profile as do the Funds”;
- the sole investor in the Enhanced Fund was a UK entity;
- the Funds’ investor registries were located in the Republic of Ireland;
- the Funds’ accounts receivable were located throughout Europe and the US;

- counterparties to the Funds' master repurchase and swap agreements were based both inside and outside the US, but none were claimed to be located in the Cayman Islands; and
- certain prepetition transactions conducted in the US may have been avoidable under US law.

Notably, the District Court also rejected certain arguments asserted by the liquidators in an attempt to establish the Cayman Islands as the Funds' COMI:

- The liquidators argued that most of the Funds' remaining liquid assets were in bank accounts in the Cayman Islands. The court rejected this argument, noting that prior to the filing of the Chapter 15 petition, all of the Funds' funds were maintained in accounts with its prime broker in the US.
- The liquidators pointed out that two of the Funds' directors resided in the Cayman Islands, but the court found this unpersuasive, noting that the liquidators did not demonstrate that those directors had "any substantial involvement in the business of the Funds."
- The liquidators claimed that the Funds' investors and creditors knew or should have known that they were dealing with entities incorporated in the Cayman Islands. However, the court found "no evidence" to suggest that the Funds' investors or creditors (other than the Bear-affiliated investors) knew or had reason to know of the Funds' Cayman Islands incorporation.
- The liquidators alleged that upon their appointment as joint provisional liquidators, the powers of the boards of directors of the Funds ceased and control of the Funds was transferred to the Cayman Islands. The court noted that these allegations, even if true, did "not constitute substantive economic activity in the Cayman Islands."
- The liquidators asserted that the Funds' pre-filings attorneys were in the Cayman Islands, that their pre-filing auditors did some auditing work in the Cayman Islands and certain of the Funds' investments were constituted under Cayman Islands law. However, according to the court, even if those facts were relevant to the COMI analysis, they were outweighed by the other facts found by the Bankruptcy Court.

No Nontransitory Economic Activity in the Cayman Islands

The District Court noted that, unlike the COMI analysis in which there is a presumption that the place of a debtor's registered office is its COMI, the existence of an "establishment" (that is, of nontransitory economic activities) "is essentially a factual question, with no presumption in its favor."

The District Court agreed with the Bankruptcy Court's finding that the liquidators had failed to put forward facts establishing that the Funds carried out nontransitory economic activities in the Cayman Islands. In this regard, the court stated that auditing activities and preparation of incorporation papers performed by a third party did not satisfy the nontransitory economic activities test. Similarly, the court rejected the liquidators' assertion that review of insider transactions constituted "economic activity." Finally, the court noted that at the time of the petition, there were no Fund assets located in the Cayman Islands. Accordingly, the court found that the Funds did not carry out even nontransitory economic activities in the Cayman Islands, and therefore denied nonmain recognition to the Cayman Islands proceedings.

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