



UPDATE

August 9, 2007

BEAR STEARNS FUNDS CHAPTER 15

The latest chapter in the unfolding drama related to the collapse of two Bear Stearns hedge funds has taken the form of provisional liquidation proceedings in the Cayman Islands, followed by Chapter 15 ancillary filings in New York by the Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. and the Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund Ltd. (the "Bear Funds"). The Chapter 15 filings seek injunctions to prevent US investors/creditors from attaching the Bear Funds' assets in the United States. This update is intended to provide some basic background regarding Chapter 15 in the hedge fund context and some of the considerations presented by the Cayman and US filings.

Chapter 15 Overview

In 2005, Congress added Chapter 15 to the Bankruptcy Code to replace the procedure formerly embodied under § 304 of the Bankruptcy Code. Chapter 15 is a specialized cross-border insolvency procedure based on a model law promulgated by the United Nations Commission on International Trade Law. Chapter 15 is designed, among other things, to promote cooperation by US courts with insolvency proceedings commenced in other countries. The typical reason for filing a Chapter 15 petition is to protect the US-based assets of a foreign debtor.

Like a Chapter 11 case, a Chapter 15 case is commenced by the filing of a petition in a US bankruptcy court. Unlike a Chapter 11 case, however, the filing of the Chapter 15 petition does not commence a full-blown US bankruptcy case and does not immediately trigger an automatic stay (though interim relief can be requested in the form of a temporary restraining order). Instead, it is an "ancillary proceeding" in aid of the relevant foreign insolvency proceeding. Procedurally, it is the "foreign representative" of the foreign debtor that files the Chapter 15 petition and controls the Chapter 15 proceedings. In most countries (including the Cayman Islands), this typically (although not always) means an independent administrator or liquidator is in charge, rather than existing management, as would be the case under Chapter 11.

The effect of a Chapter 15 proceeding is largely driven by whether the foreign proceeding is a "foreign *main* proceeding" or a "foreign *nonmain* proceeding," which, in turn, is driven by whether the debtor's "center of main interests" ("COMI") is in the jurisdiction where the foreign proceeding was commenced. There is a presumption that a debtor's COMI is its place of incorporation, but this presumption can be overcome, as was the case in the *SPhinX* matter discussed below.

If the US bankruptcy court finds that a foreign debtor's COMI is in the jurisdiction where its foreign proceeding was commenced, then the foreign proceeding constitutes a "foreign main proceeding" and a number of statutory protections are automatically triggered, including the automatic stay under § 362 of the Bankruptcy Code with respect to property in the US. In addition, the provisions of § 363 of the Bankruptcy Code require court approval of all non-ordinary course transactions regarding the debtor's business in the US, such as the sale of US assets.

Conversely, if the US bankruptcy court concludes that a foreign debtor's COMI is not in the jurisdiction where the foreign proceeding was commenced, then the proceeding is a "foreign nonmain proceeding" and there are no automatic statutory protections. Instead, the foreign representative in the foreign nonmain proceeding must prove, among other things, that the relief requested is "necessary to effectuate the purposes of [Chapter 15] and to protect the assets of the debtor or the interests of creditors." The scope of discretionary relief available is broad, but it is not unlimited.

Cayman Islands Insolvency Law in a Nutshell

Cayman insolvency law presumes jurisdiction over any entity that is registered (*i.e.*, incorporated) in the Cayman Islands. Cayman law does not have reorganization provisions *per se*, only liquidations, but the practice has developed of appointing "provisional liquidators" when greater flexibility is desired rather than a strict liquidation. "Provisional liquidation" is also common when a Cayman company has assets in another country and coordination between the two countries would be helpful in maximizing value. Recent examples of successful Cayman provisional liquidations involving US assets include ICO Global Communications and Fruit of the Loom.

The "provisional liquidators" are typically two or three "insolvency practitioners" from the Cayman office of an accounting firm. Where US assets are involved, the provisional liquidators will then seek relief in the US bankruptcy court by filing a Chapter 15 petition. After filing the Chapter 15 petition and subject to recognition by the US bankruptcy court, the foreign representative can then file a voluntary Chapter 11 petition if the foreign proceeding is a main proceeding, or an involuntary Chapter 11 petition if the foreign proceeding is a nonmain proceeding. Typically, however, the foreign representative is content with the relief generally available under Chapter 15 and will not take the further step of commencing a full-blown Chapter 11 case.

Cayman Hedge Funds and COMI/Chapter 15

The significance of the difference between main and nonmain foreign proceedings was recently illustrated in *In re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006). SPhinX, like a great many other hedge funds (including the Bear Funds), was registered in the Cayman Islands but its main operations were located in the US. As part of SPhinX's litigation strategy to challenge a settlement relating to its interests in the Refco bankruptcy case, the SPhinX fund's provisional liquidators in the Cayman Islands filed a Chapter 15 petition in New York. The provisional liquidators argued that the Cayman proceeding was a foreign main proceeding, and therefore, Chapter 15 required the imposition of an automatic stay that would, among other things, disrupt the Refco settlement.

In one of the first US decisions interpreting the phrase "center of main interests," the bankruptcy court stated that a COMI analysis should consider:

- the location of the debtor's headquarters;
- the location of those who actually manage the debtor (which conceivably could be the headquarters of a holding company);
- the location of the debtor's primary assets;
- 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/or
- the jurisdiction whose law would apply to most disputes.

Id. at 117. The court noted that the hedge fund's business was conducted in the US, the operations in the Cayman Islands were mostly back-office operations, few (if any) assets were located in the Cayman Islands, and most creditors were located outside the Cayman Islands. The court determined that these facts, together with the fact that SPhinX's provisional liquidators clearly sought to use Chapter 15 to obtain strategic leverage regarding the Refco settlement, rebutted the statutory presumption in favor of finding the Cayman liquidation to be the foreign main proceeding. Because the foreign proceeding was nonmain, the automatic stay was not triggered and the court determined not to grant a discretionary injunction against the Refco settlement.

Application of *SPhinX* to the Bear Funds

There is no immediately apparent material distinction between the day-to-day operations of the SPhinX fund and the Bear Funds. All are registered in the Cayman Islands, but all cater primarily to US investors and operate principally within the US. Thus, if the *SPhinX* decision is followed, the Cayman provisional liquidations for the Bear Funds will be construed as foreign nonmain proceedings (even though the provisional liquidators are seeking foreign main

proceeding status) and, therefore, the Chapter 15 proceedings should not automatically trigger a stay against creditor actions in the US. However, as is customary, the bankruptcy court has entered a temporary restraining order pending a formal hearing on the merits.

In the *SPhinX* case, the "nonmain" determination proved to be fatal to the relief that the provisional liquidators were hoping to obtain. However, that does not mean that the same will hold true for the Bear Funds, even assuming a "nonmain" determination. The fact that a foreign proceeding is nonmain only means that it is not entitled to automatic relief in the US. Nevertheless, Chapter 15 still permits the US bankruptcy court to grant discretionary relief, such as an injunction, that essentially provides for the equivalent of an automatic stay. Indeed, the Bear Funds' provisional liquidators have expressly requested such discretionary relief in the event the court determines that the Cayman proceedings are nonmain.

The SPhinX liquidators also requested discretionary relief in the alternative, but they were rebuffed. There, the court concluded that the Chapter 15 petition was filed for the improper purpose of seeking to disrupt a settlement reached in the Refco Chapter 11 case. In the situation of the Bear Funds, on the other hand, the initial Chapter 15 pleadings do not appear to seek controversial relief. Instead, the pleadings request the typical broad injunctive relief to prevent piecemeal attacks against the US assets. Of course, "controversial" is in the eye of the beholder, and it may be that other facts and circumstances come to light that turn the "typical injunctive relief" into anything but. For example, creditors holding security interests in US-based Bear Funds' assets may argue that broad injunctive relief harms their interests given the volatile nature of the assets (e.g., subprime mortgages). Accordingly, they may seek to avoid injunctive relief altogether, or at least seek relief from any automatic or discretionary stay so that they can promptly liquidate their collateral before values potentially deteriorate further. This will unfold shortly because responsive pleadings to the Chapter 15 petition are due to be filed before the end of the month.

It is worth noting that one important distinction between automatic and discretionary stay relief is that discretionary relief remains subject to periodic review. Thus, in theory at least, the US bankruptcy court could terminate discretionary stay relief if there has been a change of circumstances such that injunctive relief is no longer appropriate. When Parmalat commenced its Section 304 case (the predecessor to Chapter 15) in 2004, the US bankruptcy court's discretionary injunctive relief remained subject to periodic review. While the injunction was never lifted, the ability to seek periodic review provided US creditors with the opportunity to appear in court every few months to express their concerns as to various aspects of Parmalat's Italian insolvency proceedings. Periodic review will likely be important for the Bear Funds' cases, as well. If secured creditors are to be enjoined from liquidating their collateral, the creditors ought to have regular access to the US bankruptcy court in order to ensure that their collateral is being properly dealt with or, if necessary, in order to obtain relief from the stay/injunction so that they can deal with their collateral themselves if they are not being adequately protected.

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Thursday, August 30, 2007

Dear Clients and Friends

To summarize:

Earlier this afternoon, the bankruptcy court overseeing the the Bear Stearns hedge funds chapter 15 proceedings issued the attached decision denying all of the relief requested in the funds' chapter 15 petitions. The expectation was that the court would deny the funds' request that the Cayman liquidations be considered to be the "main" proceedings. Unexpectedly, however, the court also concluded that the Cayman proceedings do not even qualify as "non-main" proceedings. As a result, the court concluded that it had no authority whatsoever under chapter 15 to grant either automatic stay relief or discretionary stay relief. Instead, the court said that the funds should file a chapter 7 or chapter 11 petition if they still wanted protection from their assets in the US.

In more detail:

As discussed in our prior client alert that can be found [HERE](#), the funds were organized under Cayman law, but all of their operations and assets (other than a Cayman bank account created after their bankruptcy filings) were located in the United States. The funds filed for Cayman voluntary liquidation and then sought ancillary relief in the United States under chapter 15.

The chapter 15 petitions sought recognition as foreign "main" proceedings (which would result in certain automatic statutory protections) and foreign "non-main" proceedings (which would give rise to potential discretionary relief from the court). Although no party formally objected to the chapter 15 petitions, the bankruptcy court today denied the petitions in their entirety and held that the funds were neither foreign "main" or "non-main" proceedings. Instead, the court instructed that, if the funds wished Bankruptcy Code protection in the United States, they will need to file for a plenary bankruptcy proceeding under either chapter 7 or 11 of the Bankruptcy Code.

The bankruptcy court expressly rejected the notion that, in the absence of an objection to a chapter 15 petition, the court must simply "rubber stamp" the petition. Instead, the court held that it is incumbent upon the court, in light of the purpose of chapter 15, to examine the evidence and determine whether the foreign debtor/representative has truly satisfied its burden of proof that a foreign main or non-main proceeding has been commenced within the meaning of the statute. As expected, the court concluded that the funds' center of main interest (COMI) was not in the Cayman Islands, which means that the Cayman proceedings could not be foreign "main" proceedings. Somewhat surprisingly, however, the court continued on to conclude that the funds did not even have an "establishment" (i.e., non-transitory economic activity) in the Cayman Islands, which means that the Cayman proceedings could not be a foreign "non-main" proceeding either, because their only presence in the Cayman Islands related to their incorporation there, nothing else.

Unless overruled on appeal, today's decision sets strong precedent for other troubled hedge funds that are incorporated outside of the United States, but whose asset and operations are truly located in the United States. Such funds will seriously need to consider whether they should simply file for chapter 7 or 11 relief in the United States, or seek to challenge today's decision by filing a chapter 15 petition before another court/judge.

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