



News & Publications

**UPDATE**

SDNY Confirms Bearish Opinion on Off-Shore Hedge Fund Use of Chapter 15

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In round one of the litigation concerning whether a US Bankruptcy Court would provide Chapter 15 assistance to the liquidators of two Cayman-registered Bear Stearns hedge funds, the Bankruptcy Court for the Southern District of New York concluded that the funds were not eligible for Chapter 15 assistance. In two client updates we circulated in August 2007 (both of which can be viewed [HERE](#) ) , we explained the significance of Chapter 15 of the Bankruptcy Code (pursuant to which US courts provide assistance to foreign insolvency proceedings) and the implications of the Bankruptcy Court's denial of Chapter 15 assistance to the Bear Stearns fund liquidators.

Round two was concluded yesterday with an opinion by the District Court affirming the Bankruptcy Court's decision. The District Court opinion (which can be viewed [HERE](#) ) provides a few key takeaways for other troubled off-shore funds:

- Chapter 15 contemplates the possibility of two types of recognition of foreign insolvency proceedings. If the foreign proceeding was commenced in a jurisdiction that constituted the debtor's "center of main interests" (COMI), the proceeding is recognized as a "main proceeding" entitled to *mandatory* Chapter 15 assistance. If the foreign proceeding was commenced in a jurisdiction in which the debtor was engaged in "non-transitory economic activity" but such jurisdiction was not the debtor's COMI, then the foreign proceeding is entitled to *discretionary* Chapter 15 assistance.
- Even though Chapter 15 contains a presumption that a debtor's place of registration (incorporation) is its COMI, the debtor still must carry the evidentiary burden of proving that such place was the debtor's COMI. This is so even if the Chapter 15 petition is unopposed.
- In fact, even as to a Cayman-registered fund with Cayman directors and auditors, the debtor has the burden of proving that it was engaged in actual "non-transitory economic activity" in the Cayman Islands. Such proof will require evidence of matters such as meaningful assets in Cayman or substantial local management.
- And if a Cayman debtor cannot meet the burden of proving that the Cayman Islands is either its COMI or a place in which it carries out non-transitory economic activity, then the debtor is not entitled to any Chapter 15 assistance at all.

There is a great deal more to the District Court's opinion than the foregoing, but the main point is clear: A foreign debtor seeking Chapter 15 assistance in the US must do more than demonstrate there is an insolvency proceeding in its home jurisdiction. The foreign debtor must actually prove that it conducts substantial non-transitory business in its home jurisdiction.

We have hinted at this before but are now prepared to state it in no uncertain terms: we believe that the Bear Stearns opinions are wrong. What is far less clear is whether the error belongs in the two courts' interpretation of Chapter 15 or in the Chapter 15 statute itself. Both Bankruptcy Judge Lifland and District Judge Sweet are leading jurists in general and in cross-border matters in particular. We cannot say that their interpretation of the language of Chapter 15 is inaccurate or even that it is a stretch.

However, as mandated by the United States Supreme Court more than 100 years ago, US law has historically provided assistance to foreign debtors. If Chapter 15 as drafted has, indeed, narrowed the circumstances under which we will provide assistance, then Chapter 15 needs to be amended.

Assuming that the two Courts are correct and that Chapter 15 actually is narrower than prior law, then it is a particular irony that Chapter 15 stands in stark contrast to US law regarding eligibility of foreign debtors to be the subject of plenary Chapter 11 and Chapter 7 proceedings. The Bankruptcy Code expressly provides that an entity is eligible to commence a full Chapter 11 or Chapter 7 case if it is incorporated here, or has a place of business here, or even simply has assets here. Plenary bankruptcy jurisdiction does not require a "principal place of business," COMI, or meaningful assets in the United States. In fact, the Courts recognized that Yukos Oil was eligible for Chapter 11 relief just because it transferred minimal funds into a newly-opened US bank account (Yukos' Chapter 11 case was ultimately dismissed, but not on eligibility or jurisdictional grounds). And some courts have even found the presence of mere books and records (such as those of the Bear Stearns funds in Cayman) in the US to be sufficient to support Chapter 11 jurisdiction in US courts.

We hope that the liquidators of the Bear Stearns funds pursue an appeal to the Second Circuit Court of Appeals. If the two lower courts here are correct – and given the wording of Chapter 15, they may well be – it would be helpful to have a Second Circuit decision. In the meantime, we urge legislative reform, both in the US and in Cayman.

In the US, Chapter 15 should be amended to make clear that, at a minimum, an insolvency proceeding in a debtor's place of incorporation is eligible for discretionary Chapter 15 relief. In Cayman, we urge clarification of the fund registration statutes to detail the specific local economic activities a fund can properly engage in without running afoul of the general policy that such funds should not be competing directly with local businesses.

By approaching this issue from both ends, hopefully we will end up where we were before the Courts' interpretation of Chapter 15 – as a global economic power that is willing to provide assistance to off-shore businesses in exactly the same way we expect those off-shore jurisdictions to provide assistance to US courts.

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