

## CLIENT ALERT

### U.S. Bankruptcy Relief Blocked For Some Offshore Hedge Funds

Sep.11.2007

Following the well-publicized subprime mortgage crisis, a few hedge funds were unable to satisfy margin calls flowing from the devaluation of their asset portfolios. As a result, these funds sought relief under foreign insolvency laws and then their liquidators filed Chapter 15 petitions for relief in U.S. Bankruptcy Courts. The relatively new criteria under Chapter 15 was enacted in 2005 and implemented the Model Law on Cross-Border Insolvency. Chapter 15 is the mechanism for recognizing foreign insolvency proceedings and is being tested in the cases of the collapsed hedge funds. A recent decision by the Bankruptcy Court in Manhattan demonstrates that offshore hedge funds must be careful when seeking cross-border insolvency relief in the U.S.

On August 30, 2007, the U.S. Bankruptcy Court for the Southern District of New York blocked Bear Stearns & Co. Inc. from using Chapter 15 bankruptcy for two of its Cayman Islands registered hedge funds, which were “exempted companies” under Cayman Islands law. *See In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, Nos. 07-12383 (BRL) and 07-12384 (BRL), 2007 WL 2479483 (Bankr. S.D.N.Y. Aug. 30, 2007), amended by *Amended Decision and Order Denying Recognition of Foreign Proceeding*, dated Sept. 5, 2007, 07-12383 (BRL), ECF 26 and 07-12384 (BRL), ECF 25, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov). The *Bear Stearns* opinion, issued by Judge Burton R. Lifland, who co-authored the Model Law on Cross-Border Insolvency and Chapter 15 of the Bankruptcy Code, lays out the formulaic analysis of “recognition” of foreign proceedings under Section 1517 of the Bankruptcy Code.

As Judge Lifland explains, recognizing a foreign proceeding is “a simple single step process incorporating the definitions in sections 1502 and 101(23) and (24)” of the Bankruptcy Code. *Bear Stearns*, 2007 WL 2479483, \*3. A foreign proceeding may be recognized “as either a foreign main or nonmain proceeding.” *Id.* at \*4 (citing 11 U.S.C. § 1517(a)(1)). The Bankruptcy Code defines a “foreign main proceeding” as “a foreign proceeding pending in the country where the debtor has the center of its main interests”. 11 U.S.C. § 1502(4). A “foreign nonmain proceeding” is defined as “a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment”. 11 U.S.C. § 1502(5). An “establishment” is defined as “any place of operations where the debtor carries out a nontransitory economic activity”. 11 U.S.C. § 1502(2).

Section 1516(c) states that “[i]n the absence of evidence to the contrary, the debtor’s registered office, . . . is presumed to be the center of the debtor’s main interests.” 11 U.S.C. § 1516(c). Although this presumption is included for speed and convenience, it “is not a preferred alternative where there is a separation between a corporation’s jurisdiction of incorporation and its real seat.” *Bear Stearns*, 2007 WL 2479483, \*4 (internal citations omitted). In *Bear Stearns*, Judge Lifland found that the liquidators’ own pleadings provided evidence rebutting the presumption that the registered offices in the Cayman Islands were the debtors’ center of main interest. *Id.* at \*6. The Court determined that the hedge funds’ center of main interests is in the United States, “the place where the Funds conduct the administration of their interests on a regular basis . . . and, more specifically, [the funds’ center of main interests] is located in this district where principal interests, assets and management are located.” *Id.* at \* 6.

As for the criteria for “foreign nonmain proceedings,” the *Bear Stearns* Court observed that the “establishment” definition for “nontransitory economic activity” means that the debtor must have “a local place of business.” *Id.* at \*7. Concluding that there was no pertinent local (Cayman Islands) economic activity, the Court observed: “Here the bar is rather high, especially in view of the Cayman Islands’ statutory prohibition against ‘exempted companies’ engaging in business in the Cayman Islands except in furtherance of their business otherwise carried on *outside* of the Cayman Islands.” *Id.* at \*7 (emphasis in original) (citing Companies Law (2004 Revision) of the Cayman Islands § 193).

After blocking the Chapter 15 petitions, the Court noted that the Bear Stearns’ liquidators could obtain relief by filing involuntary bankruptcy cases under Chapter 7 or Chapter 11, pursuant to 11 U.S.C. § 303(b)(4). *Id.* at \*8. On September 10, 2007, the liquidators appealed Judge Lifland’s ruling. The appeal remains pending.

This issue also is pending in another case, *Basis Yield*, before Judge Robert E. Gerber of the U.S. Bankruptcy Court for the Southern District of New York in the *Basis Yield* case. On September 5, 2007, the liquidators for Basis Yield Alpha Fund (Master), a Basis Capital mutual fund incorporated in the Cayman Islands, filed a supplement to their petition for recognition, in which they attempt to address some of the factors set out in the *Bear Stearns* decision. *See In re Basis Yield Alpha Fund (Master)*, Case No. 07-12762, Supplement to Verified Petition for Recognition of Foreign Main Proceeding Pursuant to Section 1515 and 1517 of the Bankruptcy Code and Related Relief, dated Sept. 5, 2007, ECF 9, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov). On the same date, Citigroup filed papers with the court indicating that it may object to the Chapter 15 petition and stating that the liquidators’ supplement did not address all relevant factors. *See In re Basis Yield Alpha Fund (Master)*, Case No. 07-12762, Response of Citigroup Global Markets Limited to Debtors’ Request for Entry of Preliminary Injunction, dated Sept. 5, 2007, ECF 10, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov). A hearing on the Chapter 15 petition in *Basis Yield* has not been set yet.

Cross-border insolvency issues require careful planning in light of new Chapter 15. This is particularly crucial for offshore hedge funds, many of which are incorporated in the Cayman Islands. We will continue to follow developments concerning Chapter 15 relief and will provide updates as future decisions are rendered.

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