Legal update

Where does a hedge fund have its centre of main interests? Jennifer Marshall considers a recent decision of the US Bankruptcy Court, which is certainly no model of cross-border CoMIty.

Consider a hedge fund incorporated in a particular jurisdiction (say, the Cayman Islands) for tax, regulatory or other reasons. It has no employees but instead is administered by a separate entity with its corporate seat in another jurisdiction (Massachusetts, for the sake of argument). That is where the books and records are kept. The investment manager may be established in a third jurisdiction (for example, New York). Its assets are investment-grade securities – notoriously difficult to site under existing conflict of law rules. As for the directors, it is not inconceivable in present times that these could be jet-setting individuals with dual or multiple residencies, conducting board meetings on the hoof by way of international conference calls[1]. Where does such a hedge fund have its 'centre of main interests' for the purposes of the UNCITRAL Model Law on Cross-Border Insolvency (the Model Law) and Council Regulation (EC) No. 1346/2000 of May 29, 2000 on insolvency proceedings (the EC Insolvency Regulation)? Does such a fund have an 'establishment' and, if so, where is this located?

These questions were considered by the US Bankruptcy Court for the Southern District of New York in relation to the failed hedge funds *Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd* (Case No. 07-12383) and *Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd* (Case No. 07-12384), both casualties of the sub-prime lending crisis in the US. The Cayman provisional liquidators sought recognition, under Chapter 15 of the US Bankruptcy Code, of the Cayman liquidation proceedings as 'foreign main proceedings' or, failing that, 'foreign non-main proceedings' (or 'nonmain' as they say in the US). Although there were no objections to the applications for recognition[2], bankruptcy judge Burton Lifland refused to recognise the Cayman proceedings as he did not consider that the funds had their centre of main interests or any establishment in the Cayman Islands. Recognition was not (in his view) to be rubber-stamped by the court. The decision is being appealed but, unless and until it is overturned, it suggests that some pre-bankruptcy planning may be required to ensure recognition in the US, even in unopposed applications.

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Background

Chapter 15 of the US Bankruptcy Code was enacted in 2005 to implement in the US the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law (UNCITRAL). It is the US equivalent of our Cross-Border Insolvency Regulations 2006 although there are some key differences in the text of the two pieces of legislation (a natural consequence of the fact that the Model Law does not have automatic effect, like the EC Insolvency Regulation, but has to be enacted by the adopting country). For example, in the US, the foreign proceedings in respect of which recognition can be sought include proceedings 'under a law relating to insolvency or adjustment of debt' (which is wide enough to encompass a scheme of arrangement in relation to a solvent company) whereas the British wording simply refers to a proceeding 'pursuant to a >>

law relating to insolvency' (which would arguably not include a solvent scheme). The wording is also different in relation to the registered office presumption (more of this later).

Chapter 15 replaced the ancillary relief provisions in section 304 of the US Bankruptcy Code whereby the court had a wide discretion to grant relief in the US to a foreign insolvency officeholder without the need for a full US bankruptcy case. In the *Bear Stearns* case, the Cayman provisional liquidators sought to rely on the case law under old section 304 to emphasise the discretion and flexibility that could be exercised by the court in giving relief to foreign representatives. However, while Judge Lifland considered that much of the jurisprudence developed under section 304 was preserved by Chapter 15 (and in particular section 1507), he pointed out that there is one fundamental distinction. Before any assistance can be given under Chapter 15, the foreign proceeding has to be 'recognised' as either a main or nonmain proceeding (this was not a requirement under former section 304). There is a statutory framework for recognition – or, in other words, a procedural hoop though which foreign representatives have to jump – before any relief can be given.

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If a foreign proceeding is not recognised under Chapter 15, the foreign representative is not left without a remedy. He or she may still petition for the commencement of full bankruptcy proceedings under Chapters 7 or 11 of the US Bankruptcy Code (a point that Judge Lifland was keen to make). However, there are clearly cost implications of commencing such proceedings, as well as issues relating to their co-ordination with the foreign proceedings. For these reasons, the provisional liquidators of the Bear Stearns funds have recently announced their intention not to commence full-blown US bankruptcy cases.

Recognition as foreign main proceeding

Foreign main proceedings are defined in Chapter 15 as proceedings pending in the country where the debtor has its 'centre of main interests' (or 'center of main interests' as they say in the US). On the basis that lawyers are only happy when using four-letter, jargonistic acronyms (or FLJAs), this will be referred to as 'CoMI' for the rest of this article, thus avoiding the need to choose between the respective spellings of the 'c' word. The advantage of recognition as a main proceeding (from the foreign insolvency officeholder's point of view) is the grant of an *automatic* stay with respect to the debtor company and any property within the US. If recognition is only granted as a nonmain proceeding, relief may still be granted but this is a matter for the discretion of the court.

CoMI is not defined in Chapter 15 but there is a presumption, in the absence of *evidence* to the contrary, that it is the place of the debtor company's registered office (section 1516(c) of the US Bankruptcy Code). The wording here is different from the text of the Model Law and the British implementing legislation that refers to the registered office presumption 'in the absence of *proof* to the contrary' (article 16(3) of the Cross-Border Insolvency Regulations 2006). This begs the question as to whether there is any difference in practice between the two formulations. In the *Bear Stearns* case, Judge Lifland referred to the legislative history of Chapter 15, which explains that the word 'proof' was changed to 'evidence' to make it clearer, using US terminology, that the ultimate burden is on the foreign representative. Where there is evidence that the CoMI might be somewhere else, the foreign representative must prove that the CoMI is, in fact, in the same country as the registered office.

Comparison with the EC Insolvency Regulation

The *Guide to Enactment of the Model Law* (the guide) explains that the CoMI concept was taken from the *EU Convention on Insolvency Proceedings*, the text of which became the EC Insolvency Regulation. In interpreting Chapter 15, the US Bankruptcy Court is directed to consider its international origin and the need to promote an application that is consistent with similar statutes adopted by foreign jurisdictions. This enables the US Bankruptcy Court to look to the guide and, in turn, the case law regarding CoMI under the EC Insolvency Regulation (which also uses the 'proof to the contrary' language in respect of the registered office presumption). Unfortunately this case law is not always consistent regarding the weight that is to be given to the presumption. In *Re Eurofood IFSC Ltd* (Case C-341/04), the ECJ held that the presumption can be rebutted only if factors that are both objective and ascertainable by third parties lead to a conclusion that the CoMI is elsewhere. Where a company carries on its business in the jurisdiction of its registered office, the mere fact that its economic choices are or can be controlled by a parent company elsewhere is not enough to rebut the registered office presumption. This calls into question the earlier English decisions in which it was held that the location of the registered office is 'just another factor' to be taken into account (*In the matter of Ci4Net.com.Inc* [2004] EWHC 1941 and *Re Parkside Flexibles SA* [2006] BCC 589). At the other end of the spectrum, however, the Dutch court may have gone too far in concluding, in *BenQ Mobile Holding BV* (LJN AZ9985, Rb. Amsterdam, January 31, 2007), that the registered office presumption can only be rebutted if there are virtually no activities in the jurisdiction of the registered office.

Conclusions regarding CoMI in the *Bear Stearns* case

Judge Lifland referred to the *Eurofood* case as authority for the proposition that the registered office presumption could be overcome in the case of a 'letterbox' company not carrying out any business in the country in which its registered office is situated. He also noted that the guide explains that the presumption does not prevent other evidence being assessed if the conclusion suggested by the presumption is called into question *by the court* or an interested party. He considered that this allowed him to examine where the CoMI was located, even though no real objections to recognition had been filed. In this regard, he parted with the more flexible approach to recognition that had been taken by the US Bankruptcy Court in *In re SPhinX Ltd* (Case 06-11760). In that case (also involving companies registered in the Cayman Islands), Judge Drain held that, if the parties in interest did not object to the foreign proceedings being recognised as main proceedings, and no other proceedings had been initiated anywhere else, recognition would be granted on the basis that the companies had to be wound up somewhere[3].

In the judge's view, the pleadings of the Cayman provisional liquidators provided the evidence that the funds' CoMIs were in the United States, not the Cayman Islands. The only connection with the Cayman Islands was the location of the registered offices of the two funds. There were no employees or managers in the Cayman Islands (although two directors resided there), the investment manager was located in New York, the administrator who ran the back-office operations was in the US (along with the funds' books and records) and, prior to the commencement of the Cayman liquidations, all of the funds' liquid assets were located in the US.

Although two of the three investors in the first fund were Cayman Island companies, these were Bear Stearns entities with the same minimal Cayman Islands profile as the funds themselves. The sole investor of the other fund was a UK entity.

On this basis, could a hedge fund incorporated in a particular country for regulatory or tax reasons ever have its CoMI in the place of its registered office? The answer is clearly yes. In *Amerindo Internet Growth Fund Limited* (Case No 07-1-327), the Cayman proceedings in respect of an investment company registered in the Cayman Islands were recognised under Chapter 15 as main proceedings in circumstances where there was a Cayman Islands investment manager and a Cayman Islands administrator who maintained the books and records in the Cayman Islands and managed the debtor's day to day business there.

Recognition as nonmain proceeding

As an alternative to recognition as a main proceeding, the Cayman provisional liquidators sought recognition as nonmain proceedings on the basis that there was an 'establishment' in the Cayman Islands. In Chapter 15, this is defined as 'any place of operations where the debtor carries out a non-transitory activity' (or, as Judge Lifland put it more simply, a local place of business). The judge referred to 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 the Cayman Islands. He did not consider that the limited activities carried out in the Cayman Islands to maintain the registered office there amounted to an 'establishment' for these purposes[4].

Keeping your options open

If a foreign representative is not certain whether the debtor has its CoMI or an establishment in the place where the foreign proceedings are commenced, can a foreign representative keep his or her options open by applying for recognition on either ground (without taking a view as to whether the foreign proceedings are main or nonmain)? Judge Lifland did not think that this was possible; the application for recognition should state which type of recognition is being sought. However, in *In re Schefenacker plc* (Case No. 07-11482), the US Bankruptcy Court granted recognition without distinguishing between main and nonmain proceedings because the foreign proceeding (an English company voluntary arrangement) clearly qualified as one or the other and the relief sought (recognition of the injunction contained in the CVA) would be granted in respect of either a main or nonmain proceeding.

Conclusions

While the *Bear Stearns* decision seems correct on the basis of a literal interpretation of Chapter 15, the more

pragmatic and flexible approach adopted by the court in *Re SPhinX* has a lot to commend it. Although Judge Lifland noted that the foreign representatives could always commence full bankruptcy proceedings in the US, there would be (at the very least) increased administrative costs in having dual plenary proceedings in two jurisdictions. Some might say that, for a jurisdiction where bankruptcy proceedings have been commenced on the mere presence of a US bank account, it is a bit rich for that jurisdiction to fail to recognise proceedings commenced in the place of the company's registered office – but that is ultimately a matter of policy. Chapter 15 clearly requires the CoMI or an establishment to be in the foreign jurisdiction. The US court's decision to assess the evidence of its own motion is interesting, though. For the purposes of the EC Insolvency Regulation, an English practitioner may be forgiven for thinking that, so long as some attempt is made to put together evidence that the CoMI is in the UK, the English court will not *generally* scrutinise this too closely in unopposed cases (much to the horror of our European colleagues with their more inquisitorial-style courts).

The EC Insolvency Regulation operates on the basis of 'mutual trust' (Recital 22). The courts of one Member State should not re-examine an earlier CoMI decision of another Member State. There is no such principle under the Model Law and its implementing legislation and so each court is free to re-examine CoMI (as the US Bankruptcy Court did in the *Bear Stearns* case). It has been suggested by one Caymans' practitioner that the US court's unwillingness to recognise the Cayman proceedings may have had something to do with an inherent mistrust of the jurisdiction. Judge Lifland made frequent references to an article by J Westbrook ('Locating the Eye of the Financial Storm', 32 Brook J Int'l L 1019, 2007) in which it is suggested that the interpretation of CoMI under the Model Law should, to some extent, take account of the likely quality of the substantive law of the CoMI jurisdiction and that care should be taken in relation to 'tax havens, bank secrecy havens and the rest'. There is, of course, no such requirement under either the Model Law or Chapter 15 and the question of recognition should be based solely on whether the debtor has its CoMI or an establishment in the foreign jurisdiction.

The *Bear Stearns* decision is the subject of a pending appeal to the US District Court. Whether or not it is overturned, it would be prudent for foreign representatives to gather their evidence together before making any application for recognition in the US. It may be necessary to take steps *before* commencing any US Chapter 15 proceedings to ensure there is sufficient connection with the jurisdiction where the insolvency proceedings are to be commenced (subject to a careful review of the debtor's documents and applicable law, including tax law). In a case concerning another failed Caymans hedge fund, *Basis Yield Alpha Fund* (Case 07-12762), the US Bankruptcy judge has set out 21 factors that he wants the provisional liquidators to address in evidence regarding the debtor's connection with the Cayman Islands. The recognition hearing was scheduled for 19 November 2007. We have certainly not heard the last word on the subject of the location of hedge funds for the purposes of Chapter 15. □

"In *In re Schefenacker plc* (Case No. 07-11482), the US Bankruptcy Court granted recognition without distinguishing between main and nonmain proceedings."

[1] In fact, in the *Bear Stern* case, two of the directors resided in the Cayman Islands but this was not sufficient to rebut the registered office presumption referred to in this article.

[2] There was a request from certain Merrill Lynch entities that the centre of main interest findings should not affect the choice of law determination for any actions brought by the provisional liquidators in the US.

[3] Ultimately, Judge Drain refused to recognise the proceedings as 'main' proceedings largely on the ground of the bad faith motives of those who had commenced the Cayman proceedings. He did, however, recognise the proceedings as nomain proceedings but then refused to exercise his discretion to grant any relief.

[4] Judge Lifland did not consider that the establishment text had been addressed in *In re SPinX* where the decision to recognise the foreign proceedings as nomain proceedings was a 'pragmatic' one rather than one based on the requirements of Chapter 15.

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