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A legal update from Dechert's Finance and Real Estate and Business Restructuring and Reorganization Groups

## Bankruptcy Filings by U.S. Based Foreign Hedge Funds

*Chapter 15 was recently added to the Bankruptcy Code. The purpose of Chapter 15 is "to provide effective mechanisms for dealing with cases of cross-border insolvency." 11 U.S.C. §1501. In general, recognition of a foreign proceeding under Chapter 15 gives a U.S. bankruptcy judge greater discretion and flexibility in administering the case, and it gives a debtor additional relief (with greater benefits being conferred to proceedings recognized as foreign main proceedings), including, in some cases, application of the automatic stay of Section 362 of the Bankruptcy Code to property of the foreign debtor located within the United States.*

*A district court grants limited Chapter 15 benefits to the debtor hedge funds and suggests that if no creditors objected, the debtor could obtain the full benefits of Chapter 15.*

*In re SPhinX, Ltd., 371 B.R. 10 (S.D.N.Y. 2007)*

In this case, the debtor hedge funds were established under and regulated by Cayman Islands law. Beyond books and records required to be maintained under Cayman Islands law, however, the hedge funds had virtually no contact with or presence in the Cayman Islands (no employees were there, there were no offices there, none of the directors resided there or held board meetings there, and no assets of the funds were located there). At least ninety percent of the funds' assets were located in accounts in the United States and the business was managed pursuant to a fully discretionary investment management contract by a Delaware corporation located in New York City.

In July 2006, the debtor hedge funds filed voluntary winding up petitions in the Cayman Islands. These funds then sought to file a Chapter 15 motion and have the U.S. Bankruptcy Court for

the Southern District of New York recognize the Cayman Islands proceeding as a foreign main proceeding.

After initially recognizing the Cayman Islands proceeding as a foreign proceeding, the bankruptcy court turned to the more complex question of whether the proceeding should be recognized as a foreign main proceeding. The bankruptcy court, in making this determination, listed several factors it considered important:

- "the location of the debtor's headquarters,"
- "the location of those who actually manage the debtor,"
- "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
- "the jurisdiction whose law would apply to most disputes."

When weighing these factors, the bankruptcy court explained that flexibility is important and that the weighing should be done in light of Chapter 15's focus on protection of interested parties, fair procedures, and maximization of the debtor's value. Importantly, the bankruptcy court looked to the acquiescence of the creditors as to whether the foreign proceeding should be considered a foreign main proceeding.

The bankruptcy court found that most of these factors, as well as other pragmatic considerations, weighed against recognizing the Cayman Islands proceeding as a foreign main proceeding. However, since the case involved liquidation and not reorganization, and because virtually none of the creditors objected to the Cayman Islands proceeding, the bankruptcy court explained that it would ordinarily grant the recognition. In this case, however, the bankruptcy court found that since the primary purpose of the Chapter 15 proceeding was to halt an appeal in another U.S. litigation case, it would only recognize the Cayman Islands proceeding as a foreign nonmain proceeding.

On appeal, the District Court for the Southern District of New York affirmed. The district court agreed that the improper purpose weighed against the recognition of the Cayman Islands proceeding as a foreign main proceeding. The district court did suggest, however, that if there was no objection by the creditors then, notwithstanding that the factors weighed against recognition as a foreign main proceeding, the bankruptcy court could grant the recognition.

*A bankruptcy court denies the debtor any protections under Chapter 15, leaving open the possibility that the debtor could seek protection under other chapters of the Bankruptcy Code. In reaching this decision, the court expressly disagrees with the court in In re SPhinX, Ltd., (discussed above), from the same jurisdiction, and holds that it is irrelevant whether any creditors object.*

*In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 374 B.R. 122 (Bankr. S.D.N.Y. 2007)*

In this case, the debtor funds were open-ended investment companies with registered offices in the Cayman Islands. The administrator and investment manager of the debtor funds were both U.S. entities, and the investor registers were held in Dublin, Ireland. Virtually all of the debtor funds' assets were located in the Southern District of New York. With the exception of two directors, no employees lived in the Cayman Islands.

On July 30, 2007, after a devaluation of much of their asset portfolios, the debtor funds voluntarily sought to wind up under the supervision of the Cayman Grand Court. The debtor funds petitioned the U.S. Bankruptcy Court for the Southern District of New York to recognize the Cayman Islands proceedings as foreign main proceedings under Chapter 15 of the

U.S. Bankruptcy Code, or, in the alternative, as foreign nonmain proceedings.

The bankruptcy court looked to the same factors the court in the *SPhinX* case (discussed above) did to determine whether the Cayman Islands proceedings were foreign main proceedings. Like the *SPhinX* court, the bankruptcy court found that the factors weighed against recognition of the Cayman Islands proceedings; however, unlike the *SPhinX* court, the bankruptcy court gave no weight to whether there were creditor objections to the recognition. The bankruptcy court found that while normally there is a presumption that if the registered office of the debtor is located in the jurisdiction where the proceeding is filed, that proceeding will be recognized as a foreign main proceeding, this presumption is for administrative efficiency and does not relieve a court of its duty to make a determination that the presumption is justified. Specifically, the bankruptcy court found that where there is evidence that an entity's center of main interests is elsewhere, the foreign representative has the burden of proving the center of main interest. In this case, in light of the merely tangential connections of the business to the registered office jurisdiction of the Cayman Islands, the bankruptcy court refused to recognize the Cayman Islands proceedings as foreign main proceedings.

In order to be found to be a foreign nonmain proceeding, the bankruptcy court found that nontransitory economic activity must be conducted in that foreign jurisdiction (that is, there must be a local place of business there). Since the only activities performed in the Cayman Islands were activities to support the U.S. based business, the bankruptcy court concluded that the burden was not met and the Cayman Islands proceedings were not foreign nonmain proceedings, either.

While it refused to recognize the Cayman Islands proceedings as either foreign main or foreign nonmain proceedings, the bankruptcy court left open the option for the debtor funds to seek protection in the United States by filing under Chapter 7 or 11 of the Bankruptcy Code.

*In a third related case, a bankruptcy court denies recognition of a Cayman proceeding as a foreign main proceeding without an evidentiary hearing, finding that even where no creditors object to recognition, the court can still require evidence that recognition is appropriate.*

*In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37 (Bankr. S.D.N.Y. 2008)

In this case, much like the two cases above, the debtor was a hedge fund formed in the Cayman Islands. As a result of an economic downturn, the hedge fund filed for liquidation in the Cayman Islands. Thereafter, the representatives of the fund sought Chapter 15 recognition (either main or nonmain) in the Bankruptcy Court for the Southern District of New York. No creditors filed objections to the recognition. As a result, the representatives of the fund asked the court to grant summary judgment on their request for recognition as a foreign main proceeding. The representatives of the fund did not file any evidentiary support for their summary judgment motion.

The fund relied on a statutory presumption in Section 1516 of Chapter 15 of the Bankruptcy Code, which provides that in the absence of contrary evidence, a foreign proceeding should be recognized as a foreign main proceeding if it takes place in the jurisdiction in which the debtor is registered. The court found that

sole reliance on this presumption was misplaced. The court reasoned that it had the power to require evidence, even when there are no objections to the recognition. The court said that it was not a rubber-stamp and that a factual inquiry into whether recognition is appropriate cannot be sidestepped simply because there are no objections or because the representatives chose not to plead facts. The court found that the fund, much like the debtor funds in the cases mentioned above, had little to no contact or business in the Cayman Islands and therefore recognition would not be appropriate on summary judgment and the fund needed to present evidence to support its position.

These cases are significant because of the prevalence of U.S. based entities that are organized under foreign laws in the securitization, CDO, Repo, and hedge fund industries.



This update was authored by Katherine A. Burroughs (+1 860 524 3953; [katherine.burroughs@dechert.com](mailto:katherine.burroughs@dechert.com)) and Scott Killian (+1 860 524 3949; [scott.killian@dechert.com](mailto:scott.killian@dechert.com)).

## Practice group contacts

If you have questions regarding the information in this legal update, please contact the authors or the Dechert attorney with whom you regularly work. Visit us at [www.dechert.com/finance&realestate](http://www.dechert.com/finance&realestate) or [www.dechert.com/insolvency](http://www.dechert.com/insolvency).

### Kimberly S. Andrascik

London, Philadelphia  
+1 215 994 2520  
[kimberly.andrascik@dechert.com](mailto:kimberly.andrascik@dechert.com)

### Timothy J. Boyce

Charlotte  
+1 704 339 3129  
[timothy.boyce@dechert.com](mailto:timothy.boyce@dechert.com)

### Lewis A. Burleigh

Boston  
+1 617 654 8601  
[lewis.burleigh@dechert.com](mailto:lewis.burleigh@dechert.com)

### Katherine A. Burroughs

Hartford  
+1 860 524 3953  
[katherine.burroughs@dechert.com](mailto:katherine.burroughs@dechert.com)

### Ciaran P. Carvalho

London  
+44 20 7184 7473  
[ciaran.carvalho@dechert.com](mailto:ciaran.carvalho@dechert.com)

### Lawrence A. Ceriello

New York  
+1 212 698 3659  
[lawrence.ceriello@dechert.com](mailto:lawrence.ceriello@dechert.com)

### Steven Choo

London  
+44 20 7184 7370  
[steven.choo@dechert.com](mailto:steven.choo@dechert.com)

### Laura G. Ciabarra

Hartford  
+1 860 524 3926  
[laura.ciabarra@dechert.com](mailto:laura.ciabarra@dechert.com)

### Patrick D. Dolan

New York  
+1 212 698 3555  
[patrick.dolan@dechert.com](mailto:patrick.dolan@dechert.com)

**Malcolm S. Dorris**  
New York  
+1 212 698 3519  
malcolm.dorris@dechert.com

**Dr. Olaf Fasshauer**  
Munich  
+49 89 21 21 63 28  
olaf.fasshauer@dechert.com

**Ethan D. Fogel**  
Philadelphia  
+1 215 994 2965  
ethan.fogel@dechert.com

**Steven A. Fogel**  
London  
+44 20 7184 7444  
steven.fogel@dechert.com

**David W. Forti**  
Philadelphia  
+1 215 994 2647  
david.forti@dechert.com

**William Fryzer**  
London  
+44 20 7184 7454  
william.fryzer@dechert.com

**Joseph V. Gatti**  
Washington  
+1 202 261 3436  
joseph.gatti@dechert.com

**John J. Gillies, Jr.**  
Hartford  
+1 860 524 3938  
john.gillies@dechert.com

**Joseph B. Heil**  
San Francisco  
+1 415 262 4510  
joseph.heil@dechert.com

**Bruce D. Hickey**  
Boston  
+1 617 654 8602  
bruce.hickey@dechert.com

**Geoffrey K. Hurley**  
New York  
+1 212 698 3598  
geoffrey.hurley@dechert.com

**Andrew Hutchinson**  
London  
+44 20 7184 7428  
andrew.hutchinson@dechert.com

**Eric P. Iversen**  
New York  
+1 212 698 3538  
eric.iversen@dechert.com

**Shalom Jacob**  
New York  
+1 212 698 3818  
shalom.jacob@dechert.com

**Les Jacobowitz**  
New York  
+1 212 698 3814  
les.jacobowitz@dechert.com

**Richard D. Jones**  
Philadelphia  
+1 215 994 2501  
richard.jones@dechert.com

**Andreas Junius**  
New York  
+1 212 698 3578  
andreas.junius@dechert.com

**Abradat Kamalpour**  
London  
+44 20 7184 7856  
abradat.kamalpour@dechert.com

**David M. Linder**  
San Francisco  
+1 415 262 4511  
david.linder@dechert.com

**Ralph R. Mazzeo**  
Philadelphia  
+1 215 994 2417  
ralph.mazzeo@dechert.com

**Steven J. Molitor**  
Philadelphia  
+1 215 994 2777  
steven.molitor@dechert.com

**Sean H. Porter**  
New York  
+1 212 698 3579  
sean.porter@dechert.com

**Jason S. Rozes**  
Philadelphia  
+1 215 994 2830  
jason.rozes@dechert.com

**Glenn E. Siegel**  
New York  
+1 212 698 3569  
glenn.siegel@dechert.com

**Timothy A. Stafford**  
New York  
+1 212 698 3504  
timothy.stafford@dechert.com

**William C. Stefko**  
New York  
+1 212 698 3895  
william.stefko@dechert.com

**H. Jeffrey Schwartz**  
New York  
+1 212 698 3682  
h.jeffrey.schwartz@dechert.com

**Barry J. Thorne**  
London  
+44 20 7184 7413  
barry.thorne@dechert.com

**Charles I. Weissman**  
New York  
+1 212 698 3847  
charles.weissman@dechert.com



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