BANKRUPTCY COURT REFUSES TO RUBBER STAMP RELIEF UNDER CHAPTER 15 OF THE BANKRUPTCY CODE

In a recent decision and order, Judge Burton R. Lifland of the United States Bankruptcy Court for the Southern District of New York (the Bankruptcy Court) delivered an important ruling regarding the eligibility of foreign debtors with significant assets and operations in the United States to gain access to chapter 15 of title 11 of the United States Code (the Bankruptcy Code) as part of a strategy to liquidate or reorganize pursuant to the laws of a foreign jurisdiction. Judge Lifland found that the prospective hedge fund debtors (the Funds) were ineligible for relief under chapter 15 because the Funds had sought the entry of winding up orders in the Grand Court of the Cayman Islands (the Cayman Grand Court) under the provisions of the Companies Law of the Cayman Islands (the Foreign Proceedings) despite the fact that the Cayman Islands is not the location where each Fund had its "center of main interests" or where either had an "establishment." In implementing his ruling, Judge Lifland ordered the continuation of the preliminary injunction order of August 9, 2007, issued pursuant to section 1519 of the Bankruptcy Code, for a period of 30 days from the date of the original decision and order (*i.e.*, August 30, 2007) so as to give the parties in interest an opportunity to file a petition for relief under chapter 7 or 11 of the Bankruptcy Code in the district where the seat of the Funds' management functions is located. In essence, Judge Lifland's ruling requires the Funds to liquidate or reorganize under U.S. law or risk a chaotic "grab" by creditors for their U.S.-based assets.

Chapter 15

Chapter 15 was added to the Bankruptcy Code by title VIII of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to encourage cooperation between the United States and foreign countries with respect to transnational insolvency cases. This new chapter of the Bankruptcy Code, which replaced former section 304 of the Bankruptcy Code, incorporates the Model Law on Cross-Border Insolvency promulgated in 1997 by the United Nations Commission on International Trade Law.

Section 1501(a) of the Bankruptcy Code sets forth the purpose and the following five objectives of chapter 15: (i) to encourage cooperation between courts of the United States (including the United States trustee and appointed fiduciaries) and foreign courts in cross-border insolvency cases; (ii) to provide greater legal certainty for trade and investment; (iii) to promote the fair and efficient administration of cross-border insolvencies in a way that protects the interests of all creditors, the debtor and other interested entities; (iv) to protect and maximize the value of the debtor's assets; and (v) to facilitate the rescue of financially troubled businesses with the goal of protecting investments and preserving employment. Relief under chapter 15 is designed to protect the interests of the debtor and its creditors through an orderly administration of the bankruptcy estate and to promote fairness for both local and foreign creditors. Chapter 15 facilitates ancillary relief in a broader structure that mandates cooperation with foreign courts

and foreign representatives and coordination of multiple proceedings involving a common debtor. Chapter 15 cases are generally intended to be supplementary to cases brought in the debtor's home country; however, chapter 15 does not prevent commencement of a plenary case under another chapter of title 11 either before or after recognition has been granted by a bankruptcy court to a foreign representative of a foreign proceeding.

Background Facts

In the instant case, following the volatility in the market related to the United States sub-prime lending, the Funds began to suffer a significant devaluation of their respective asset portfolios. This devaluation of the asset portfolios led to margin calls from many of the Funds' trade counterparties which the Funds were unable to meet, resulting in the issuance of default notices by those counterparties and their exercise of rights under their respective agreements to seize and/or sell the assets of the Funds.

In response to this liquidity crisis, the Funds commenced the Foreign Proceedings in the Cayman Islands to affect an orderly liquidation of the Funds' assets. On July 31, 2007, the Cayman Grand Court entered orders appointing joint provisional liquidators of the Funds (the JPLs). Immediately thereafter, the JPLs sought relief from the Bankruptcy Court under chapter 15 of the Bankruptcy Code, contending, among other things, that: (i) the Bankruptcy Court's recognition of the Foreign Proceedings would not be contrary to public policy under section 1506; (ii) the Foreign Proceedings were "foreign main proceedings" as defined in section 1502(4); and (iii) the JPLs were persons authorized in the Foreign Proceedings to administer the liquidation of the Funds' assets in the Cayman Grand Court. In the alternative (if the Bankruptcy Court found that the Foreign Proceedings were not eligible for recognition as foreign main proceedings), the JPLs sought recognition of the Foreign Proceedings as "foreign nonmain proceedings," as defined in section 1502(5), and thereby entitled to permissive relief under chapter 15.

The Bankruptcy Court's Decision

Judge Lifland determined that, for the purposes of chapter 15 of the Bankruptcy Code, the analysis of whether a foreign proceeding constitutes a "foreign main proceeding" turns on whether the foreign proceeding is pending in a country in which the center of the debtor's main interests is located. Although the location of a debtor's registered office is presumptively the center of its main interest, Judge Lifland (relying on legislative history and caselaw) concluded that if there is evidence that the center of main interests might be elsewhere, then the foreign representative must prove that the debtor's center of main interests is in the same country as its registered office. Judge Lifland did not elaborate on the types of evidence required to rebut the presumption that the center of main interests is the debtor's place of registration; however, his decision provides a non-exhaustive list of factors that are relevant to such a determination, including: (i) the location of the debtor's headquarters; (ii) the location of those who actually manage the debtor (which, conceivably, could be the headquarters of a holding company); (iii) the location of the debtor's primary assets; (iv) the location of the debtor's principal place of business; (v) 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 (vi) the jurisdiction whose law would apply to most disputes.

Here, Judge Lifland found that the following factors constituted sufficient evidence to rebut the presumption that each Fund's center of main interests was located in the Cayman Islands: (i) the Funds had no employees or managers in the Cayman Islands; (ii) the investment manager for the Funds was located in New York; (iii) the administrator that ran the Funds' back-office operations was located in the United States along with the Funds' books and records; (iv) prior to the commencement of the Foreign Proceedings, all of the Funds' liquid assets were located in the United States; (v) the Funds' investor registries were maintained and located in the Republic of Ireland; (vi) the Funds' accounts receivable were located throughout Europe and the United States; and (vii) counterparties to master repurchase and swap agreements with the Funds were based both inside and outside the United States, but none were domiciled in the Cayman Islands. As such, the foreign representatives failed to carry their burden of proving that each Fund's center of main interests was located in the Cayman Islands and, thus, precluded the Bankruptcy Court from recognizing the Foreign Proceedings as foreign main proceedings.

Next, Judge Lifland analyzed the eligibility requirements of "foreign nonmain proceedings" under section 1502(5) of the Bankruptcy Code. Judge Lifland held that, in order for a bankruptcy court to recognize a foreign proceeding as a nonmain proceeding under chapter 15, the foreign representative must demonstrate that the debtor had an "establishment" in the foreign jurisdiction in question for the conduct of nontransitory economic activity – *i.e.*, a local place of business where business was actually and regularly conducted. Based on the factors utilized in the center of main interests analysis, Judge Lifland concluded that there was no pertinent nontransitory economic activity conducted locally in the Cayman Islands by the Funds, rather, the Funds' only activities in the Cayman Islands were necessary for their respective offshore "businesses."

Finally, Judge Lifland noted that, although much of the jurisprudence developed under section 304 of the Bankruptcy Code is preserved in the context of the new section 1507, section 304 did not have a recognition requirement as a first step. Section 304 simply gave bankruptcy courts the authority to open an ancillary proceeding and grant various broad forms of relief to the foreign representative. Chapter 15, on the other hand, imposes a rigid procedural structure for recognition of foreign proceedings as either main or nonmain proceedings and, thus, the jurisprudence developed under section 304 is of no assistance in determining the issues relating to the presumption for recognition under chapter 15.

Conclusion

While the decision provides that bankruptcy courts should not recognize foreign proceedings under chapter 15 of the Bankruptcy Code without appropriate scrutiny, it does not expound upon the individual factors to be weighed in that analysis. Accordingly, further judicial experience will be needed to provide practitioners with greater guidance on these issues.

* * * * * * * * * * * * * * *

If you have any questions about this memorandum, please contact Michael Kelly (212-728-8686, mkelly@willkie.com), Matthew Feldman (212-728-8651, mfeldman@willkie.com), Steven Szanzer (212-728-8879, sszanzer@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

September 26, 2007

Copyright © 2007 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.