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TheBrief

What price COMI-ty?

Amid some fanfare in 2005, the USA implemented the UNCITRAL Model Law on Cross-Border Insolvency by enacting Chapter 15 of the United States Bankruptcy Code. It contained, for the first time in such legislation, an express statement of purpose: to facilitate cooperation between US and foreign courts, office-holders and debtors so as to maximize assets and recoveries and to protect the interests of creditors and other stakeholders.

The new Chapter 15 was lauded by practitioners and academics as ushering in a new period of unprecedented cross-border cooperation in insolvency matters: foreign office-holders were to be given easy access to the debtor-friendly protective regime of the US Bankruptcy Code (which shields the company from third party claims and seizures of assets), while at the same time being left free to pursue litigation claims in the US courts (and elsewhere) on behalf of creditors, who might otherwise recover little or nothing from insolvent companies.

This proved popular as anticipated, and by 2006 over 50 Chapter 15 filings had been made by foreign office-holders. It is particularly popular for insolvent master/feeder funds, where the master/feeder structure requires one or more onshore and offshore companies to be liquidated simultaneously.

However, two recent decisions in the US Bankruptcy Court in New York threaten to severely curtail recourse to Chapter 15, which may in turn force fund promoters to rethink the way in which their funds are structured in the first place.

The Court's first denial of an application for

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recognition of a "foreign main proceeding" came in 2006, concerning the SPhinX funds liquidation. In that case, the Court's reasoning was heavily influenced by its perception that the proceedings were an abuse of the Court's process (to frustrate a settlement of claims arising out of the Refco collapse), but it was at least prepared to recognize the Cayman liquidation as a "foreign non-main proceeding" and thus to confer discretionary protection on the funds. This decision nevertheless laid down a marker and a precedent for deployment by aggrieved US-based interests in the future.

Then came the much-publicized collapse of the US sub-prime mortgage market. Its first casualties in the funds sector were two Bear Stearns funds (Bear Stearns High-Grade Structured Credit Strategies Master Fund and Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund), one of which was highly leveraged and both were hopelessly insolvent. On 31 July 2007, they petitioned the Cayman court for the appointment of provisional liquidators under a Court-supervised (rather than voluntary or out-of-Court) liquidation; the same day of their appointment, the provisional liquidators sought and obtained from the Bankruptcy Court in New York Chapter 15 recognition and, more importantly, interim protection for the funds against third party claims and seizures of assets.

News of this event provoked vehement criticism throughout the US media, with allegations that Bear Stearns had just pulled a stunt to protect their own position. Among the critics was Professor Jay Westbrook: he claimed that the Cayman courts make it difficult for interested parties to take legal action, being "much less transparent than American courts" and "attractive to management".

Such comments are sadly misconceived and misplaced. It is true that there is less scope for class actions, and no opportunity for RICO-type punitive damages claims, in the Cayman courts; it is also true that as long as a fund is operating healthily, the "majority rule" principle in company law will allow little recourse for unhappy minority shareholders. But once fully-fledged ("official") as opposed to merely provisional liquidators are appointed, the Cayman legal system is in fact more creditor-friendly than the US bankruptcy regime, which is rather more debtor-friendly. Cayman is just as transparent in its insolvency processes, especially with its emphasis on the involvement of liquidation committees overseeing the activities of liquidators, who in turn have no compunction about pursuing US-based managers, advisers or others through the US courts in respect of defaults. This tradition was set by the liquidation of Bank of Credit and Commerce International which, 16 years on, is still the world's largest and most successful multi-jurisdictional corporate insolvency – largely thanks to the unstinting efforts of its liquidators to recover value for creditors through a massive programme of litigation claims; a tradition which has continued in other mega-insolvencies like Parmalat and fund insolvencies like Beacon Hill and Manhattan Investment Fund.

In any event, just 30 days later the Bankruptcy Court in New York discharged its earlier order, holding the Bear Stearns funds ineligible to apply for Chapter 15 recognition or protection, and requiring the provisional liquidators to start again with the less-advantageous proceedings available under Chapter 11 of the Bankruptcy Code.

Two lines of reasoning are apparent in the Court's ruling, one having potentially serious ramifications for the offshore funds industry and the other being more sinister. First, the Court considered that the Bear Stearns funds did not have their "COMI" (center of main interests) in the Cayman Islands, a pre-requisite to the grant of relief under Chapter 15: there were no employees or managers in Cayman, nor any significant assets. This evidence served to rebut the statutory presumption that the COMI was their registered office in Cayman.

By itself, this decision might be defensible on its facts (and thus likely to survive an appeal): the operating mind and management of the Bear Stearns funds were clearly in the USA, such that its

COMI should properly be held to be New York. The consequence is that a fund all of whose investment manager, advisor, administrator, custodian and prime broker are outside the Cayman Islands cannot expect that if it goes into liquidation in Cayman it will be classified as a "foreign main proceeding" under Chapter 15. Fund promoters wishing to establish master/feeder funds in the current economic climate (especially those whose investments may be difficult to value or to sell at short notice) must now give serious consideration to improving their prospects of establishing Cayman as their COMI: this will be important not only in the event of outright insolvency, but even if the fund just needs a moratorium on enforcement of secured party rights during a liquidity crisis or a plunge in NAV.

How far must they go? The boundaries have not yet been set by the Bankruptcy Court, but this may occur in the near future. The most recent sub-prime-invested fund to collapse, the Basis Yield Alpha Fund, will have its request for Chapter 15 protection considered later this month. With that fund, the Investment Adviser and Administrator are both incorporated in Cayman, while other service providers and stakeholders are based in other countries outside the USA (principally Australia). There is a sense among the profession that, if the Basis Fund does not qualify as a "foreign main proceeding" on the basis that its COMI is in Cayman, there will be almost none that does – which could turn Chapter 15 into a closed book for the offshore funds industry.

The second line of reasoning in the Bear Stearns case is more troubling. The Court held that the provisional liquidation in Cayman could not even qualify as a "foreign non-main proceeding" (which would also allow for the discretionary grant of protection under Chapter 15) on the grounds that they did not have "an establishment for the conduct of non-transitory economic activity", which the Court interpreted to mean "a local place of business" in the Cayman Islands. It relied on the nature of "exempt" companies incorporated in Cayman (which are prohibited from engaging in local business except in furtherance of business otherwise carried on elsewhere) as being inconsistent with their having such an establishment. Such reasoning is flawed, since it ignores or at least misinterprets the crucial exception in the statutory definition of "exempt" (for example, exempt companies can get local trade & business licences for the purpose of employing people in Cayman, even though the business is servicing foreign clients). However, unless this decision is reversed or departed from in future cases, it could serve to disqualify any offshore fund that is incorporated as an exempt company (as the overwhelming majority of funds are). It threatens to make the Chapter 15 consideration an all-or-nothing issue for fund promoters, and undermines the distinction drawn between "main" and "non-main" proceedings in the Bankruptcy Code.

In support of the Court's reasoning, much weight was placed on certain academic commentary concerning the intended scope and effect of Chapter 15 by Professor Westbrook, who was acknowledged in the Court's ruling as "along with myself [the Judge], among the authors of the Model Law and Chapter 15". The unfortunate consequence of this, when taken together with the professor's widely-publicized remarks referred to above, is to generate a distinct impression of judicial xenophobia towards Cayman's legal system. Countering this will require more than encouraging industry players to give thought to establishing a COMI for their funds: it will require some broader or deeper education of the US bankruptcy judges, and those who influence their thinking, in relation to the sophisticated and accessible insolvency regime which has been operating successfully in the Cayman Islands for many years.

Should you have any questions or requests for further information please contact Jeremy Walton, Partner, by email at jwalton@applebyglobal.com.

The Right People. The Right Places.

Bermuda

Canon's Court
22 Victoria Street
PO Box HM 1179
Hamilton HM EX
Bermuda

Tel +1 441 295 2244
Fax +1 441 292 8666

British Virgin Islands

Palm Grove House
PO Box 3190
Road Town
Tortola
British Virgin Islands

Tel +1 284 494 4742
Fax +1 284 494 7279

Cayman Islands

Clifton House
75 Fort Street
PO Box 190
Grand Cayman KY1-1104
Cayman Islands

Tel +1 345 949 4900
Fax +1 345 949 4901

Hong Kong

5511 The Center
99 Queen's Road Central
Central
Hong Kong

Tel +852 2523 8123
Fax +852 2524 5548

Jersey

PO Box 207
13-14 Esplanade
St Helier
Jersey JE1 1BD
Channel Islands

Tel +44 (0)1534 888 777
Fax +44 (0)1534 888 778

London

2nd Floor
2 Royal Exchange Bldgs
London EC3V 3LF
United Kingdom

Tel +44 (0)20 7283 6061
Fax +44 (0)20 7469 0540

Mauritius

Level 11
One Cathedral Square
Jules Koenig Street
Port Louis
Mauritius

Tel +230 203 4300
Fax +230 210 8792