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The *Bear Stearns* Appeal

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Since September 2007, the ability to secure recognition for foreign proceedings in US bankruptcy courts has been the subject of some uncertainty. Between Judge Lifland's decision in the *Bear Stearns* case and Judge Gerber's decision in *In re Basis Yield*, both in the Bankruptcy Court for the Southern District of New York, the recognition process that was almost routine in bankruptcy cases under section 304 was no longer so. While those judges were clear in their refusal to apply a rubber stamp to requests of foreign representatives seeking recognition in their courtrooms, some litigants and commentators were unsure whether the decisions were anomalous or signaled a new direction in the law.

It is now apparent that the new line of cases is here to stay. On 27 May 2008, Judge Lifland's ruling was upheld on appeal by Judge Sweet of the New York's US District Court in *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd*, No. 07-8730. While a higher court could still weigh in on the issue in a different case, foreign representatives can no longer take Chapter 15 recognition for granted.

The prospect for change first became apparent in September 2007, when Judge Lifland refused to recognise an offshore proceeding, even when no party objected; the foreign representative had failed to prove that the debtor's presence in the Cayman Islands constituted either a Centre of Main Interests ('COMI') or an 'establishment' under the US law that incorporated the UNCITRAL Model Law on Insolvency's foreign recognition rules. In January 2008, Judge Gerber found that there were questions of fact that prevented him from finding a COMI or establishment in the Caymans for a similarly situated debtor. The *Bear Stearns* appeal in the District Court gives these rulings added force, signaling to other bankruptcy courts that Judges Lifland and Gerber were on the right path.

The *Bear Stearns* appeal focused on a familiar set of facts. Insolvent hedge funds managed assets in New York and maintained books and records in Delaware, but were registered in the Cayman Islands. Their Cayman Islands presence was primarily formal: Two of the three investors were also registered Caymans companies, some cash was directed to Cayman Islands accounts after the bankruptcy filing, and two of the funds' directors – albeit directors who were not shown to have any substantial involvement in the fund's business – resided in the Caymans. Some attorneys for the funds resided in, and some auditing had taken place in, the Islands. But as 'exempted' companies under Cayman Islands law, the funds were not permitted to conduct any local business.

After financial trouble hit and Joint Provisional Liquidators ('JPLs') were appointed in the Cayman Islands, the JPLs sought to have the foreign proceeding recognised under the US Bankruptcy Code's Chapter 15, which provides for recognition of either 'main' or 'nonmain' foreign proceedings. For a proceeding to be recognised as 'main', the foreign proceeding must be in the country of the debtor's COMI; for it to be recognised as 'nonmain', it must be in a country where the debtor has an 'establishment' under the bankruptcy law. The JPLs sought to have their Cayman Islands proceeding recognised as either a main or nonmain proceeding. Judge Lifland rejected both of these arguments.

In their appeal in the District Court, the *Bear Stearns* JPLs argued that basic principles of comity weighed in favor of recognising the Cayman Islands proceeding. They argued that Chapter 15 'was enacted to foster comity', and courts should apply it 'pragmatically, based on their understanding that recognition should be withheld only in very limited circumstances'. Judge Sweet noted that under Chapter 15's predecessor statute, that argument might have been successful, as 'all relief under section 304 was discretionary and based on subjective, comity-influenced factors'. He also pointed out that under Chapter 15 and the UNCITRAL Model Law on Insolvency, comity was given little weight. The new analysis was more mechanical, looking at a single criterion. This approach sought to eliminate 'the risk of competing claims from foreign proceedings for recognition as the main proceeding' and thus ensure greater predictability and reliability than a comity-based approach could achieve. Judge Sweet rejected the JPLs' attempt to rely on comity.

Turning to their argument that the foreign proceeding was a 'main' proceeding, Judge Sweet addressed the JPLs' claim that the funds' COMI was in the Cayman Islands. Their first argument was primarily statutory: Under Chapter 15, a debtor's registered office 'is

presumed' to be the COMI 'in absence of evidence to the contrary', which the JPLs argued established a COMI unless some other party opposed recognition – and the JPL's petition here was unopposed. Judge Sweet interpreted the statutory language as 'creat[ing] no more than a rebuttable evidentiary presumption' that either another party *or the court* could challenge, and that required, in cases in which the COMI was not clear, evidence of where the debtor's COMI was. The burden of providing that evidence was on the party seeking to establish recognition.

With that standard established, the rest of the main-proceeding argument was relatively straight-forward, and followed the analyses of Judges Lifland and Gerber in their earlier decisions. When faced with a 'letterbox company', Judge Sweet reasoned, a court should look to the location of more substantive economic activities. He pointed to the locations of the debtor's headquarters, the debtor's actual managers, the debtor's primary assets, the creditors whose interests are at stake, and the applicable law, as being relevant. Rejecting the European Court of Justice's decision in *In re Eurofood IFSC Ltd.*, 2006 ECR I-3813, as lacking sufficient factual detail to determine where particular activities had occurred, Judge Sweet concluded that there was no basis to find the debtor's COMI to be in the Cayman Islands. That proceeding could not qualify as a foreign main proceeding.

The non-main analysis was similar. On non-main proceedings, the question is whether the debtor has an 'establishment' in the country, which the Bankruptcy Code defines as 'any place of operations where the debtor carries out nontransitory economic activity'. The Court concluded that the funds' Cayman Islands activities did not satisfy that definition: 'Auditing activities and preparation of incorporation papers performed by a third party do not in plain language terms constitute 'operations' or 'economic activity' by the Funds'. The assets that the funds transferred into Cayman Islands accounts after filing for bankruptcy did not help the JPLs' argument, since a non-main proceeding is to deal only with assets that are either located in or closely connected to the location; the funds' lack of assets in the Cayman Islands when they filed for bankruptcy suggested that a non-main proceeding there would be inappropriate.

The *Bear Stearns* appeal may not be the final word. Foreign representatives in other proceedings could still seek US recognition in a district other than the Southern District of New York, and try to persuade that other court that Judge Sweet's decision is incorrect. Foreign representatives in another case, even in the Southern District, could appeal the issue further, and ask the United States Court of Appeals for the Second Circuit, the appellate court that sits above the SDNY, to reach a different conclusion. Even if the decision stands, nothing in it should be interpreted as the death knell of Chapter 15. That decision, like the initial *Bear Stearns* decision and the *Basis Yield* ruling, is tied to the facts of the case. Debtors with more substantial offshore operations will be able to argue that their offshore operations are sufficiently limited to protect the debtor's status as an 'exempt company' under local law and sufficiently robust to constitute a COMI or establishment under Chapter 15. While there is always room for the law to evolve, Judge Sweet's decision clearly states that the framework of Chapter 15 is different from section 304. Foreign representatives had best take that new framework into account when crafting their insolvency strategy.

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