

2008

International Secured Transactions and Insolvency

Roberts Susan Jaffe

Recommended Citation

Roberts Susan Jaffe, *International Secured Transactions and Insolvency*, 42 INT'L L. 529 (2008)
<https://scholar.smu.edu/til/vol42/iss2/18>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in *International Lawyer* by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

International Secured Transactions and Insolvency

SUSAN JAFFE ROBERTS*

I. Recognition of Foreign Main and Nonmain Proceedings Under United States' Chapter 15

This year's report considers two decisions from the second half of 2007 that have contributed to a new body of cases interpreting the provisions of chapter 15 of the United States Bankruptcy Code (the "Bankruptcy Code")¹ defining when a U.S. bankruptcy court will recognize a cross-border insolvency proceeding as a foreign main or nonmain proceeding: *In re SPhinX, Ltd.* ("SPhinX")² and *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.* ("Bear Stearns").³ The Southern District of New York decided the SPhinX and Bear Stearns cases within sixty days of each other; yet their results are not entirely uniform. The two cases provide practitioners with specific guidelines as to when a U.S. bankruptcy court will recognize a foreign main proceeding, thus providing the foreign debtor with the protections available under Section 1520.⁴ The *Bear Stearns* case, however, departed from the *SPhinX* case in determining that a petition for recognition—whether for a main or nonmain proceeding—will not necessarily be granted. A petition will not be granted, even where there are no objections to the petition, if the petitioner does not meet its burden of proof to demonstrate that the foreign debtor's center of main

* Ms. Roberts is an Associate Attorney in the Bankruptcy Section at Whiteford, Taylor & Preston, L.L.P (U.S., Baltimore, Maryland).

1. Chapter 15 of the Bankruptcy Code was enacted in 2005 to incorporate the Model Law on Cross-Border Insolvency formulated by the United Nations Commission on International Trade Law ("Model Law" and "UNCITRAL") so as to provide effective mechanisms for dealing with cases of cross-border insolvency. 11 U.S.C. § 1501(a) (2006).

2. 371 B.R. 10 (Bankr. S.D.N.Y. 2007). The *SPhinX* case was decided on July 5, 2007.

3. 374 B.R. 122 (Bankr. S.D.N.Y. 2007). The *Bear Stearns* case was decided on September 5, 2007.

4. See *id.*; *SPhinX*, 371 B.R. 10. Upon being granted recognition as a foreign main proceeding, the foreign debtor may avail itself of the benefits of the automatic stay; the use, sale, or lease of property pursuant to section 363; avoidance of postpetition transfers as under section 549; acquisition of post-petition property free of liens and encumbrances unless previously bargained for under a valid pre-petition security agreement, and authority to operate the debtor's business and exercise the powers of a trustee. See also 11 U.S.C. § 1520(a)(1), (2), (3) (2006).

interest (COMI) is in the country of the registered office or where it has an establishment.⁵

A. RECOGNITION OF FOREIGN MAIN PROCEEDINGS

Chapter 15 defines a foreign main proceeding as “a foreign proceeding pending in the country where the debtor has the center of its main interests.”⁶ “In the absence of evidence to the contrary, the debtor’s registered office . . . is presumed to be the center of the debtor’s main interests.”⁷ As both *Bear Stearns* and *SPhinX* show, the results of the inquiry do not stop there.

In both cases, the debtors seeking recognition were registered in the Cayman Islands, and in both cases, the courts found that the centers of the debtors’ main interests were not located in the Cayman Islands because they were nothing more than “letterbox compan[ies] not carrying out any business in the [territory of the Member State] in which its registered office is situated.”⁸ In the *SPhinX* decision, the court initially undertook the inquiry rather than simply allowing the COMI presumption of Section 1516(c) to operate because objections were brought to the petition.⁹ But, the *SPhinX* court’s chief reason for

5. See *Bear Stearns*, 374 B.R. at 130 (“To the extent that non objection would make the recognition process a rubber stamp exercise, this Court disagrees with the dicta in the *SPhinX* decision.”). As a matter of note, Judge Burton Lifland, who decided the *Bear Stearns* case, was among the authors of the Model Law and chapter 15 of the Bankruptcy Code. See *id.* at 127, n.3.

6. 11 U.S.C. § 1502(4) (2006).

7. 11 U.S.C. § 1516(c) (2006).

8. *SPhinX*, 371 B.R. at 19; see *Bear Stearns*, 374 B.R. at 129. The SPhinX debtors are a group of investment vehicles organized under Cayman Islands laws to track certain Standard & Poor’s hedge fund indices. *SPhinX*, 371 B.R. at 13. The SPhinX Funds were established as offshore entities to attract non-U.S. and U.S. tax-exempt investors. *Id.* at 16. Although regulated in the Cayman Islands, the SPhinX debtors did not conduct trade or business in the Cayman Islands; they had no employees or physical offices in the Cayman Islands; and they had no assets in the Cayman Islands. *Id.* Additionally, it was acknowledged that substantially all of the SpHinX debtors’ assets are located in the United States. *Id.* The SPhinX Cayman Island proceedings were commenced by certain SPhinX investors in order to prevent the approval and consummation of a settlement of a \$312 million preference action by Refco against SPhinX. *Id.* at 13. In a prior decision, the court determined that the SPhinX debtors’ Cayman Island proceedings were not eligible for recognition as foreign main proceedings. See *In re SPhinX, Ltd.*, 351 B.R. 103, 122 (Bankr. S.D.N.Y. 2006). That decision was appealed in the case under discussion.

Like the SpHinX debtors, the Bear Stearns debtors are Cayman Islands exempted limited liability companies with registered offices in the Cayman Islands. *Bear Stearns*, 374 B.R. at 124. The books and records of the Bear Stearns debtors are maintained and stored in Delaware by PFPC, Inc. (Delaware), a Massachusetts corporation. *Id.* Bear Stearns Asset Management Inc., a New York corporation, is the investment manager of the Bear Stearns debtors, and the assets managed are located in the Southern District of New York. *Id.* Various receivables of the Bear Stearns debtors are receivables of broker dealers, nearly all of whom are located in New York. *Id.* The investment registers are held in Dublin, Ireland by an affiliate of PFPC, Inc. *Id.* at 125. The only assets of the Bear Stearns debtors located in the Cayman Islands are funds transferred to accounts in the Cayman Islands after the filing of the Chapter 15 petition. *Id.* The *Bear Stearns* Cayman Islands cases were commenced due to the devaluation of their asset portfolios in connection with the U.S. sub-prime lending market collapse. *Id.*

9. See *SPhinX*, 371 B.R. at 18. The Court stated:

As recognized by the Bankruptcy Court: “The legislative history [] indicates that the statutory presumption of § 1516(c) may be of less weight in the event of a serious dispute: ‘[t]he presumption that the place of the registered office is also the center of the debtor’s main interest is included for speed and convenience of proof where there is no serious controversy.’” *In re SPhinX*,

denying recognition as a foreign main proceeding was that the *SPhinX* petition was brought in bad faith, for the improper purpose of collaterally attacking the Refco bankruptcy court's approval of the Refco –SPhinX settlement.

In contrast, although there were no objections to the *Bear Stearns* petition for recognition either as a foreign main proceeding or even a foreign nonmain proceeding, the court concluded that the two hedge funds did not qualify for either. The *Bear Stearns* court set forth a coherent set of principles for approval of a petition that is likely to provide the precedent for all Chapter 15 cases going forward.

First, although Section 1516(c) creates a statutory presumption in favor of the debtor's registered office as its center of main interests, courts "must make an independent determination as to whether the foreign proceeding meets the definitional requirements of Sections 1502 and 1517 of the Bankruptcy Code."¹⁰ Second, the petitioning debtor bears the burden of proof to present evidentiary documents beyond the mere recitation that the debtor's registered office is in the jurisdiction in which the foreign proceeding is pending.¹¹ The presumption is not preferred where there is a separation between a corporation's jurisdiction of incorporation and its real seat of operations.¹² Third, although the Bankruptcy Code does not set forth specific factors relevant to determination of the debtor's true center of main interests, various factors may be applied, including: "the location of the debtor's headquarters; the location of those who actually manage the debtor (which, conceivably could be the headquarters of a holding company); 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/or the jurisdiction whose law would apply to most disputes."¹³ Essentially, this is the "principal place of business" in U.S. law.¹⁴ A further consideration may be the existence of pre-peti-

Ltd., 351 B.R. at 117 quoting H.R.Rep. No. 109-31, pt. 1, at 112-13 (2005), U.S.Code Cong. & Admin.News 2005, pp. 88, 174-76). Thus, the Bankruptcy Court indicated that "because . . . the vast majority of the parties in interest tacitly support that approach, normally the Court would recognize the Cayman Islands proceedings as main proceedings." *Id.* at 121. Indeed, were it not for the efforts to disrupt the SPhinX Settlement, there may have been no objections to recognition of the Second Cayman Proceedings as foreign main proceedings.

SPhinX, 371 B.R. at 18. This "pragmatic" approach of the *SPhinX* court goes to the heart of the *Bear Stearns* court's disagreement, as even without objections to recognition, the *Bear Stearns* court would have refused to recognize the proceedings as either a foreign main proceeding or even as a foreign nonmain proceeding. *See Bear Stearns*, 371 B.R. at 131.

10. *Bear Stearns*, 374 B.R. at 126.

11. *Id.* at 127-128 ("The registered office . . . does not . . . have special evidentiary value and does not shift the risk of nonpersuasion, i.e., the burden of proof, away from the foreign representative seeking recognition as a main proceeding."). Rather, the function of the presumption is to allow quick action in cases where speed is essential yet allowing for challenges to the recognition of the debtor's true COMI where the facts are doubtful. *See id.*

12. *Id.*

13. *Id.* at 128. The Court notes that these factors are not exclusive and that the Guide to Enactment of the UNCITRAL Model Law on Cross-Border insolvency is a source for persuasive consultation as to the meaning and purpose of Chapter 15's provisions. *Id.* at 129.

14. Under the EU Convention, "the place where the debtor regularly conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." *Id.* at 129 (citing *In re Tri-Cont. Exchange Ltd.*, 349 B.R. 627, 633-634 (Bankr. E.D. Cal. 2006).

tion transactions conducted in the United States that might be avoidable under U.S. law.¹⁵

Practitioners therefore should infer from the *Bear Stearns* and *SPhinX* decisions that a petition for recognition as a foreign main proceeding under Chapter 15 will only be granted after the bankruptcy court determines that the petitioning debtor satisfies its burden of showing that it meets the definitional requirements of Sections 1502 and 1517 of the Bankruptcy Code, and that the petition is filed in good faith and not for any improper purpose. It should be further noted that these principles are not in contradiction to the European Court of Justice's *Eurofoods* decision, which held that the center of the main interests of a debtor's company is presumed to be the place of the registered office *where the debtor regularly administered its business interests*.¹⁶ Under *Eurofoods*, the mere fact that a company's economic choices may be controlled by a parent company in another Member State is not enough to rebut the presumption that the registered office is the center of main interests *if the company actually carries out business in the territory of the Member State where its business is registered*.¹⁷ The condition of actually carrying out business in the territory of the registered office is exactly the requirement found lacking in the *Bear Stearns* and *SPhinX* cases because those debtors were "letterbox" companies, not carrying out any business in the territory of the Member State in which their registered offices were situated.¹⁸

B. RECOGNITION OF FOREIGN NONMAIN PROCEEDINGS

The *Bear Stearns* court also declined to follow the *SPhinX* court's decision to grant the *SPhinX* debtors' petition for recognition as a foreign nonmain proceeding. The *SPhinX* court concluded that, although recognition as a foreign main proceeding was inappropriate for the reasons discussed above, "pragmatic considerations" as well as the conclusion that "no negative consequences would appear to result" supported recognition of the Cayman Islands proceedings as nonmain proceedings.¹⁹ The *Bear Stearns* court, however, distinguished the *SPhinX* court's decision on the ground that the *SPhinX* court had not addressed the "establishment" requirement for recognition as a foreign nonmain proceeding under 11 U.S.C. § 1502(5).²⁰

Section 1502(5) provides that a "foreign nonmain proceeding" means a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment.²¹ An establishment is defined as "any place of operations where the debtor carries out nontransitory economic activity."²² Thus, in order for a court to grant a debtor's petition for recognition of a foreign nonmain proceeding, the petitioning

15. 375 B.R. at 130. Upon examination of these factors, the Court denied the petition for recognition because "each of the Funds' real seat and therefore their COMI is the United States, the place where the Funds conduct the administration of their interests on a regular basis and is therefore ascertainable by third parties, . . . and . . . is located in this district where principal interests, assets and management are located."

16. See Case C-341/04, In re Eurofood IFSC Ltd., 2006 E.C.R. I-3813, ¶ 29.

17. *Id.* at 37 (emphasis added).

18. *SPhinX*, 371 B.R. at 19; *Bear Stearns*, 374 B.R. at 129.

19. *SPhinX*, 371 B.R. at 19.

20. *Bear Stearns*, 374 B.R. at 131.

21. 11 U.S.C. § 1502(5).

22. 11 U.S.C. § 1502(2).

debtor must show that the pending proceedings are in a country where the debtor carries out nontransitory economic activity.²³

The *Bear Stearns* court denied the petitioning debtors such recognition because they could not establish that the companies carried out any nontransitory economic activity. The court focused on the fact that as exempt companies under Cayman Islands law, the companies by definition could not trade in the Islands, the place of the pending proceedings, “except in furtherance of the business of the exempted company carried on *outside* the Islands.”²⁴ Under this analysis, a “letterbox” company, such as exempt companies under Cayman Islands law, will not be granted recognition of foreign nonmain proceedings because they do not carry out any nontransitory [that is, permanent] business.²⁵

C. AVENUES FOR RELIEF FOR FOREIGN DEBTORS WHO HAVE NOT BEEN GRANTED RECOGNITION

While a foreign debtor who has not been granted recognition will be denied the benefits of the automatic stay, for instance, through chapter 15’s protections, the *Bear Stearns* court noted that the debtors still had potential remedies available. The filing of an involuntary case under chapters 7 or 11 of the Bankruptcy Code is one example.²⁶ In making this observation, the *Bear Stearns* court disagreed with the 2005 decision of *U.S. v. J.A. Jones Construction Group L.L.C.*, which held that in the absence of recognition under chapter 15, a federal court has no authority to grant a stay of litigation to a foreign debtor.²⁷ Section 1509(f) offers a second avenue of relief. It provides that denial of recognition does not affect the right of the foreign representative to sue in a court of the United States or to collect or recover a claim which is property of the estate.²⁸ The *Bear Stearns* debtors have appealed the denial of recognition, arguing that the bankruptcy court’s decision was erroneous and that the principle of comity and chapter 15’s simple documentary process for granting recognition warranted recognition of the debtor’s Cayman Islands proceedings as foreign main proceedings.²⁹ It seems likely that the *Bear Stearns* decision will be affirmed, given the court’s solid explication of the statute, its purposes, and the facts and circumstances underlying the decision.

23. See *Bear Stearns*, 374 B.R. at 131.

24. *Id.* (quoting Companies Law (2204 Revision) of the Cayman Islands § 193 (emphasis added)).

25. *Id.* The bankruptcy code does not define nontransitory economic activity. Rather, the definition of “establishment” as being a place where the debtor carries out nontransitory economic activity is taken from the Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency, U.N. G.A., UNCITRAL 30th Sess., U.N. Doc. A/CN.9/442 (1997) (“Guide”). See also Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23(2005).

26. *Bear Stearns*, 374 B.R. at 132; 11 U.S.C. § 303(b)(4) (2006).

27. See *Bear Stearns*, 374 B.R. at 132 (citing *U.S. v. J.A. Jones Constr. Group L.L.C.*, 333 B.R. 637 (E.D.N.Y. 2005)).

28. *Id.* at 133; 11 U.S.C. § 1509(f) (2006).

29. In re *Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, No. 07 Civ. 8730 (S.D.N.Y. 2007). Because there were no actual objectors to the petition for recognition, the court has allowed the filing of amicus curiae briefs in response to the appellant’s brief. One such brief supporting the Bankruptcy Court’s decision has been filed by Professor Jay Westbrook of the University of Texas School of Law, Daniel Glosband of Goodwin Proctor LLP, and Professor Kenneth N. Klee, of the UCLA School of Law. Brief for Jay Westbrook et al. as Amici Curiae Supporting Appellee, In re *Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, No. 07 Civ. 8730 (S.D.N.Y. 2007).

