How Tax Haven Entities Falter in U.S. Bankruptcy Courts

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This paper discusses the paradox facing the thousands of hedge funds incorporated in offshore tax havens such as Bermuda and the Cayman Islands.¹ When placed in insolvency proceedings in the jurisdiction of their incorporation, several of these funds have been denied access to United States bankruptcy courts based on the principle of nonrecognition. Finding that the activities and assets of these funds are primarily located in the United States, such courts have refused to acknowledge the foreign proceedings. Without recognition, United States courts grant practically no assistance to the foreign proceeding. While those same courts invite the liquidators of these funds to file a discrete plenary filing in the United States, the Bankruptcy Code contains an apparent proscription against such a voluntary filing without recognition. Having no relief with respect to an offshore fund’s United States assets, foreign liquidators are trapped; they have no practical way to stop creditors from igniting a disorganized race to recovery. In the interest of market stability by way of predictability and certainty, the issue should be addressed.

I. INTRODUCTION

As economies of the world have become increasingly intertwined, the story of an insolvent debtor with assets and liabilities spread across several countries is now commonplace. For years, courts have struggled with how to reorganize or liquidate these cross-border debtors in an organized manner that appropriately respects the laws of impacted nations. Accordingly, a uniform law that seeks to synchronize insolvency laws became a matter of inevitability.


¹ There are approximately 10,000 global hedge funds; nearly 34% of such funds are registered in the Cayman Islands, while 6% and 3% are registered in the British Virgin Islands and Bermuda, respectively. See THE CITY UK, HEDGE FUNDS 4 (2012).
Insolvency (the “Model Law”).\textsuperscript{2} To date, eighteen countries have adopted a form of the Model Law.\textsuperscript{3} With the 2005 enactment of the Bankruptcy Abuse Protection and Consumer Protection Act ("BAPCA"), the Model Law, in the form of Chapter 15, was added to title 11 of the United States Code (the “Bankruptcy Code” or the “Code”). Chapter 15 follows the Model Law “as closely as possible,”\textsuperscript{4} but the few minor deviations made by Congress have caused considerable interpretive challenges.

While the Code previously addressed international insolvency in the form of Section 304, it did so without express reference to the laws of other nations, and it only addressed ancillary assistance to a proceeding taking place elsewhere. Chapter 15, being the product of international collaboration, is an attempt at harmony. It is also an expansion of laws beyond “classic ancillary proceedings,”\textsuperscript{5} contemplating the coordination of simultaneous plenary cases in a foreign country and in the United States.

Like most statutory schemes of recent vintage, there is a notable amount of unsettled law in this territory; it is not uncommon to find areas of contention in newly minted statutory regimes, particularly those that are in their first iteration. But if the drafters of the Model Law find a need to make any changes, they will face a challenge. Any statutory change with respect to an unworkable or problematic area of the Model Law will require action on the part of UNCITRAL. Further, for those changes to have

\textsuperscript{3} Status 1997 UNCITRAL Model Law on Cross-Border Insolvency, UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW, http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html (last visited Apr. 16, 2012) (signatories as of this writing are Australia, Canada, Colombia, Eritrea, Greece, Japan, Mauritius, Mexico, Montenegro, New Zealand, Poland, Republic of Korea, Romania, Serbia, Slovenia, South Africa, the United Kingdom of Great Britain and Northern Ireland, and the United States of America).
\textsuperscript{4} Jay Lawrence Westbrook, \textit{Chapter 15 At Last}, 79 AM. BANKR. L.J. 713, 719 (2005) [hereinafter Westbrook, \textit{At Last}].
\textsuperscript{5} \textit{Id.} at 717.
any legal effect, adopting nations will each have to change their version of the Model Law, which is a rather unlikely, or at the very least, difficult task. Consider that it took seven years to adopt Chapter 15 in the United States, notwithstanding that “it received virtually unanimous bipartisan support.”\textsuperscript{6} Chapter 15, like many pieces of legislation was “held hostage” because it was included in a broader and more controversial bankruptcy reform bill.\textsuperscript{7} In summation, there is no reason to expect that further changes—even minor ones—will be easy. Considering the Herculean obstacles to updating its text, Chapter 15 will likely evolve through the judiciary and UN\textsuperscript{11}CITRAL guidance publications.

The financial crisis of 2008 brought to light a critical ambiguity in Chapter 15 that, as it has been interpreted in numerous cases, may prevent certain foreign debtors from access to United States courts. Investment funds incorporated in offshore tax havens such as Bermuda and the Cayman Islands typically are maintained and operated everywhere except where they are actually formed. Such offshore funds characteristically have few connections with their country of incorporation (in most instances, they are prohibited from even carrying on business in that country),\textsuperscript{8} until, of course, they become insolvent. The wave of these sorts of liquidation proceedings brought about by the 2008 financial crisis tested the flexibility of Chapter 15; many of these cases presented a statutory question with no clear answer, and several prominent jurists settled the uncertainty in a way that effectively shut some of these funds out of court. The more accepted interpretations of Chapter 15 have potentially denied tax haven

\textsuperscript{6} See Westbrook, \textit{At Last}, supra note 4, at 719.
\textsuperscript{7} \textit{Id}.
\textsuperscript{8} See, \textit{e.g.}, Companies Law § 193 (2004) (Cayman Is.).
entities access to the relief a debtor enjoys under United States law; case law has created “a class of unprotected orphaned debtors.” This resolution affects not only the thousands of hedge funds incorporated offshore, but also the United States-based parties that would have an interest in the potential disposition of their respective estates.

Chapter 15 is a conduit through which a debtor in the midst of foreign proceedings is granted access to United States courts. In order to obtain such access, the debtor must be “recognized” by the court. Because of a statutory construct defining recognition as either main or nonmain, if a debtor does not fit into either category, the proceeding will not receive recognition at all. Under a separate provision of Chapter 15, a nonrecognized debtor is likely unable to file under Chapters 7 or 11 of the Code. The question then, is whether the Model Law intended such an outcome. Many, including several of the Model Law’s co-authors, insist that this outcome is necessary. Others disagree. The Court of Appeals for the Second Circuit is currently considering the precise issue, but in the meantime, some district courts have crafted various approaches and workarounds. The Southern District of New York has affirmed practically opposite viewpoints in the landmark Bankruptcy Court cases of In re SPHinX, Ltd. and In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. and there is case law that falls squarely in between. A major goal of Chapter 15 is to provide “greater

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legal certainty for trade or investment.” 16 The current landscape of judicial unpredictability is potentially disruptive to the planning and administration of offshore hedge funds, and thus affects the efficient deployment of capital in financial markets. This paper attempts to explore the problem—hopefully positing several solutions along the way—by digesting prominent offshore “tax haven” fund insolvency case law to date, addressing the pros and cons of the various approaches taken. In order to appreciate these approaches, an overview of the recognition process is in order.

II. THE ROADMAP: AN OVERVIEW OF RECOGNITION

Recognition is the sentinel standing between foreign debtors and the gates of United States courts, and the Code’s definition of the word “recognition” is the sentinel’s long sword, a formidable weapon that prevents certain debtors from passing through these gates. Recognition is defined as “the entry of an order granting recognition of a foreign main proceeding or foreign nonmain proceeding.”17 The difference between designation as a main or nonmain proceeding generally relates to whether particular relief is automatically granted upon such recognition. If the proceeding is recognized as main, Section 1520 grants certain automatic application of statutes found in chapters 3 and 5 of the Code. 18 By way of example, the automatic stay goes into effect upon main recognition. If the proceeding is designated as nonmain, the application of those statutes

18 § 1521 (generally, sections that become applicable are §§ 361, 362, 363, 549 and 552).
is at the court’s discretion “where necessary to effectuate the purposes of [Chapter 15] and to protect the assets of the debtor or the interests of the creditors.”\textsuperscript{19}

A plain reading of the statute implicitly provides that there is no recognition unless the foreign proceeding is either a main or nonmain proceeding. If the debtor’s proceeding does not fall into either of those categories, the debtor is generally foreclosed from utilization of Chapter 15. The question is whether every legitimate (filed in good faith and not contrary to public policy) foreign proceeding should be one or the other, or whether some should be neither. \textit{Bear Stearns} is the seminal case that advances the latter notion, at least from a Chapter 15 statutory standpoint. Written by Judge Lifland, a co-author of the Model Law,\textsuperscript{20} the \textit{Bear Stearns} opinion carries considerable weight in the ongoing recognition debate. The UNCITRAL Judicial Perspective notes “[i]mplicitly, the UNCITRAL Model Law does not provide for recognition of other types of insolvency proceedings, for example those commenced in a State where there is only a presence of assets.”\textsuperscript{21} The Guide to Enactment further states, “the Model Law does not envisage recognition of a proceeding commenced in a foreign State in which the debtor has assets but no establishment.”\textsuperscript{22} Authority thus tilts in favor of the idea that the drafters of the Model Law had nonrecognition in mind.\textsuperscript{23}

\textsuperscript{19} § 1521(a).
\textsuperscript{20} \textit{Bear Stearns I}, 374 B.R. at 127 n.3.
\textsuperscript{23} See also 11 U.S.C. § 1509(f) (“failure of a foreign representative . . . to obtain recognition under this chapter . . . .”).
Professor Westbrook, another Model Law co-author, discusses the benefit of keeping insolvency proceedings out of “Outlier” jurisdictions when they don’t belong there, finding that many such jurisdictions have opaque and unpredictable laws. But did the drafters intend to shut out entities that have legitimate issues requiring resolution in the United States? Such a result would seem dubious, but it is increasingly a reality. Nobody directly challenges the competency of the offshore judicial systems at the heart of this paper. Courts have found similarities between the Code and its offshore counterparts, and a cursory review of commentary and judicial opinions yields no significant criticism of the insolvency procedures of the Cayman Islands, the British Virgin Islands, or other similar offshore tax haven jurisdictions. The mere fact that the funds are incorporated to shield their investors—many of whom are legitimate tax-exempt foreigners and organizations—from tax liability is no reason to deprive them of access to United States courts.

Investors know when they are investing in an offshore fund; accordingly, we must assume that they have contracted for an offshore insolvency proceeding. Perhaps such investors prefer the swiftness and rigidity of these liquidations. This is not meant to be a ringing endorsement of the Cayman Islands system; the point is that parties involved in

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25 See, e.g., *In re Nat’l Warranty Ins. Risk Retention Group*, 384 F.3d 959, 963 (8th Cir. 2004) (“[T]he liquidators have the duty and ability to act impartially and evenhandedly among the different competing interests. . . . [T]he Cayman Companies Law [is] similar to but not exactly the same as the Bankruptcy Code. All ordinary unsecured creditors are treated the same and local creditors do not have preference over foreign creditors. Companies Law provides for the prevention of fraudulent transfers if the payment is made with an improper motive.”)

26 Kenneth Krys, the *SPhinX* liquidator, noted that Cayman Islands liquidations involve a very straightforward pari passu distribution of assets. Visit to the New York University School of Law Cross-Border Insolvency Class by Kenneth Krys, Chief Executive Officer, KRYs Global (Apr. 17, 2012) (discussing *SPhinX*).
a Cayman Islands fund probably invest and lend with the assumption that their funds will be liquidated in a Cayman Islands proceeding. The uncertainty surrounding what assistance such proceedings will receive with respect to United States assets is undermining what could be otherwise smooth and predictable liquidations. As one commentator succinctly notes, “this amounts to an unnecessary encroachment of a U.S. policy choice on the business judgment of participants and investors in offshore entities and the sovereignty of those nations hosting them.”

We have established that the hiccup is recognition; with its importance brought to the forefront, what has emerged since Bear Stearns is a line of somewhat erratic case law attempting to explore the idea of recognition’s mighty prerequisites: main and nonmain proceedings.

Main and nonmain proceedings are defined in the Code. A main proceeding is one “pending in the country where the debtor has the center of its main interests.” The concept of a debtor’s center of main interests (“COMI”) has been litigated thoroughly, and is discussed infra. A nonmain proceeding is one “other than a foreign main proceeding, pending in a country where the debtor has an establishment.” At the crux of these definitions is the prevailing view that if a court determines that a foreign debtor does not have its COMI, or at the very least, an establishment in the country where its foreign proceeding is taking place, such a debtor will not be entitled to any recognition. The heart of the statutory problem created by Chapter 15 is that courts are finding offshore funds to have neither a COMI nor an establishment in the country in which their

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27 Brock, The Assault II, supra note 9, at 74.
29 § 102(5) (emphasis added).
foreign proceeding is taking place, and such debtors might have no other place to go to seek the relief that will yield the greatest overall preservation of value to the estate.

A. COMMENCING THE CASE

The road to recognition begins with a general proposition that any foreign insolvency proceeding brought to the United States is presented to the court by a foreign representative. A foreign representative is “a person or body…authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor’s assets or affairs or to act as a representative of such foreign proceeding.”\(^\text{30}\)

A foreign representative that has initiated insolvency proceedings in another country will attempt to access United States courts in one of two ways. The foreign representative may commence a plenary case under the Bankruptcy Code, meaning generally a Chapter 7 or Chapter 11 case.\(^\text{31}\) This parallel filing scheme is appropriate in large and complex bankruptcies, but makes less sense in the many instances where the costs of several full-blown proceedings exceed the benefits of a discrete process. Alternative to a plenary filing, the debtor may commence an ancillary case under Chapter 15, and in such an event, Chapter 15 will control the entire proceeding.\(^\text{32}\) Ancillary filings provide the debtor with many of the same protections it would receive under Chapter 7 or Chapter 11, and thus, such filings are preferable in most instances.\(^\text{33}\)

Whether the debtor proceeds by way of a plenary or an ancillary case, recognition is required.

\(^\text{30}\) § 102(24).
\(^\text{31}\) § 1511(2).
\(^\text{32}\) § 1504.
\(^\text{33}\) While ancillary proceedings are generally more efficient, certain well-known provisions of the Code, such as avoidance law, are not accessible to foreign debtors.
To commence a plenary case, the foreign representative will look to 11 U.S.C. §1511, which states that such a case may be brought as a voluntary case or an involuntary case. The case may be brought as a voluntary case only “if the foreign proceeding is a foreign main proceeding.”34 As discussed, this involves finding a debtor’s COMI in the country where the foreign proceeding is taking place. To file an involuntary case, the Code directs the a party to Section 303 (in the domestic context, this section is generally employed by creditors to force a debtor into bankruptcy), which states that the case may be brought “by a foreign representative of the estate in a foreign proceeding concerning such person.”35 Issue number one is that a foreign representative is not entitled to participate as a party in interest until the foreign proceeding is recognized.36 Simply stated “Chapter 15 makes clear that recognition is required before a foreign representative may avail themselves of the federal courts.”37 Issue number two is that he is only entitled to bring that case “upon recognition.”38 The petition for either a voluntary or involuntary case “must be accompanied by a certified copy of an order granting recognition.”39 As the legislative report accompanying Chapter 15 states in no uncertain terms, “an order granting recognition is required as a prerequisite to the use of Sections 301 and 303 by a foreign representative.”40 The upshot is that recognition is required to commence a discrete plenary case.

35 § 1511(a)(1) (directing the reader to 11 U.S.C. § 303(b)(4)).
36 § 1512
39 § 1511(b).
There are more accepting viewpoints regarding whether a plenary case may be brought forward without recognition. Judge Lifland notes in *Bear Stearns* that “Section 303(b)(4) does not require that the foreign proceeding be recognized.” \(^{41}\) He invited a plenary filing, stating, “An involuntary case may be commenced under chapter 7 or chapter 11 of the Bankruptcy Code.” \(^{42}\) This does not square with Section 1511.

Still, perhaps it is true that Section 303(b)(4) *alone*—that is, without considering the text of Chapter 15—does not require recognition. In that event, viewed in isolation, Section 303(b)(4) seems to open the door to the option of commencing a plenary case. The interplay between Section 303(b)(4) and Section 1511(a), however, closes that door, allowing the plenary filing under Section 303 only “upon recognition.” The *Bear Stearns* court notes that “the failure to repeal section 303(b)(4) along with section 304 may be a drafting error” and that “[t]he inconsistencies of the two statutes have not been conformed.” \(^{43}\) The court is referring to the fact that Section 303(b)(4) was in place well before the adoption of Chapter 15. Regardless of whether Section 303(b)(4) should have been repealed, it is difficult to fathom a way around the clear recognition requirement of Section 1511(a), which is really the statute that must be addressed to solve this enigma. Judge Lifland is not alone in his accommodative view. A judge’s handbook for managing cross-border insolvencies states:

In those instances where the judge concludes that the foreign representative represents neither a foreign main proceeding nor a nonmain proceeding, the foreign debtor with assets in the U.S. is not without remedy. A full plenary

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\(^{41}\) *Bear Stearns I*, 374 B.R. at 132.

\(^{42}\) *Id.*

\(^{43}\) *Id.* at 132 n.15.
proceeding (either a voluntary or involuntary chapter 11 or chapter 7) may still be filed if the requirements for filing a domestic case are met.\footnote{HON. LOUISE DECARL ADLER, MANAGING THE CROSS-BORDER INSOLVENCY CASE, A POCKET GUIDE FOR JUDGES 13 (2011).}

Thus, while the Code requires recognition, in an effort to provide some form of domestic judicial attention to unrecognized debtors, judges appear to favor flexibility. The only logic that could support such a viewpoint is that if a foreign proceeding fails to receive recognition, Chapter 15 is inapplicable altogether. If the chapter is inapplicable, so is the requirement found in Section 1511(a). This logic is rather untenable; it is difficult to ignore the recognition requirement. Finding Chapter 15 to be inapplicable in the case of a conflicting foreign proceeding further undermines the scope of Chapter 15, which must be applied whenever “a foreign proceeding and a case under [the Code] with respect to the same debtor are pending concurrently.”\footnote{11 U.S.C. § 1501(b)(3)}

In any event, a clear workaround is not forthcoming in the Code. And while this inconsistency has been pointed out in commentaries and even in a docketed response to the \textit{Bear Stearns} amicus brief,\footnote{Appellants’ Reply to Brief of Amici, \textit{In re: Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.}, 389 B.R. 325 (No. 07-12383) (2008), 2008 WL 872891. See Timothy T. Brock, \textit{The Assault on Offshore Tax Havens in Bear Stearns Undermines New Chapter 15: Part I}, 26 AM. BANKR. INST. J. 34, 79 (2008) [hereinafter Brock, \textit{The Assault I}] (“The \textit{Bear Stearns} Court asserted that § 303(b)(4) ‘does not require that the foreign proceeding be recognized’ in order for a foreign representative to commence an involuntary chapter 11 case. Not so.”) (Citations omitted).} it has not been squarely addressed by Model Law drafters or the courts. Inability to file a plenary case seems to be the death knell to the theory that entities in unrecognized foreign proceedings—at least by way of a voluntary proceeding—will have their day in United States Courts.
While the requirement for recognition may be something of an open question with regards to a plenary filing, there is no debate about its clear place in an ancillary case. The ancillary case itself is commenced by filing a petition for recognition,\footnote{11 U.S.C. § 1504 (2012).} without recognition, Chapter 15 is essentially of no use.

**B. RECOGNITION PROCESS**

Recognition is governed by Section 1517 of the Code. Before considering whether the proceeding is main or nonmain, a court must determine whether the case before it is a foreign proceeding at all. The Code defines the term “foreign proceeding,”\footnote{§ 101(23).} and the definition has been parsed to require that it be “(1) collective in nature; (2) be judicial or administrative; (3) be pending in a foreign country; (4) be under a law relating to insolvency or adjustment of debt; (5) subject the assets and affairs of the debtor to the control and supervision of a foreign court; and (6) be for the purpose of reorganization or liquidation.”\footnote{In re British American Ins. Co. Ltd., 425 B.R. 884, 901 (Bankr. S.D. Fla. 2010).} While the definition of foreign proceeding is beyond the scope of this discussion, the reader should note that failure to meet all of the elements of foreign proceeding will make the recognition debate moot; Chapter 15 will not be applicable, and a judge will likely not even undertake a recognition analysis in making such a determination.

Once the court determines that the petition for recognition relates to a foreign proceeding—and most offshore fund liquidations meet this threshold—the court must make a determination of whether such proceeding is main or nonmain. We have already established that if it is neither, the case will not be recognized.
Without recognition, a debtor is in murky water, having no protection of the Code.\textsuperscript{50} Chapter 15 does envision an unrecognized debtor, stating “failure…to obtain recognition under this chapter does not affect any right of the foreign representative to sue in a court in the United States to collect or recover a claim which is the property of the debtor.” But armed only with a limited right to sue, an unrecognized foreign proceeding is in a worse situation without recognition; the many benefits (for debtor and creditor alike) of a collective liquidation or reorganization are cast aside for a process of fragmented lawsuits.

As either (i) a COMI or (ii) an establishment is required for any form of recognition under Chapter 15, the concepts underlying these two terms will be discussed in turn.

**III. COMI**

The COMI concept has been the subject of significant litigation because the term “center of main interests” is undefined in the Code. The statutory zinger determining a debtor’s COMI is located in Section 1516(c), which states “[i]n the absence of evidence to the contrary, the debtor’s registered office…is presumed to be the center of the debtor’s main interests.”\textsuperscript{51} Through this section, Chapter 15 appears to lend some credence to a debtor’s place of incorporation as being its COMI (the “COMI Presumption”), but judges and commentators have significantly scaled down this idea.

\textsuperscript{50} 11 U.S.C. § 1520.
\textsuperscript{51} § 1516.
*Bear Stearns* is an interesting starting point in the COMI discussion because it addressed a hedge fund incorporated in the Cayman Islands—where it first filed for insolvency proceedings—but with no activities there.52 The fund was completely administered from New York, yet its registered office was offshore.53 Strictly interpreting Section 1516(c), considering that there was no evidence presented to the contrary by either of the parties, and further accounting for the fact that the motion for recognition was uncontested,54 one might think the case screams for main recognition.

Judge Lifland found “evidence to the contrary” of the fund’s COMI in the very petitions the foreign representatives filed in seeking recognition. Citing a landmark European case that defined COMI, and further citing the Guide to Enactment, Judge Lifland stressed that not only could the COMI Presumption be overcome in the case of “letterbox” companies, in instances like this, the presumption should be “called into question by the court.”55 The court agreed with the position of Professor Westbrook in finding that “the Model Law and Chapter 15 give limited weight to the presumption of jurisdiction of incorporation as the COMI.”56

Considering the *Bear Stearns* court found evidence against finding COMI in the four corners of the petition for the recognition, what if a foreign representative files a “strikingly silent” petition as to where a debtor’s assets or activities are located?57 As the foreign representatives of another Cayman Islands fund discovered (this fund failed because it invested in structured credit securities, typically backed by mortgages), courts

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52 *Bear Stearns I*, 374 B.R. at 130.
53 *Id.*
54 *Id.* at 129.
55 *Id.* at 129 (quoting Guide to Enactment, *supra* note 22, at ¶ 122).
56 *Bear Stearns I* at 129 (quoting Westbrook, *Locating the Eye, supra* note 24, at 6).
may undertake their own examination and find enough evidence to rebut the statutory presumption. 58 Bear Stearns and Basis Yield Alpha Fund stand for the proposition that “recognition [] is not a rubber stamp exercise.” 59

A European court recently disagreed with Judge Lifland’s approach. In discussing the COMI for the failed Antiguan bank headed by Allen Stanford, his lordship Justice Lewison found that United States courts diverge from European courts with respect to determining COMI. Noting the differences between Chapter 15, which uses “evidence to the contrary,” and the Model Law, which refers to “proof to the contrary,” he remarked:

Judge Lifland said that except where there is no contrary evidence the registered office does not have any special evidentiary value. This change in language of the enactment, as it seems to me, may well explain why the jurisprudence of the American courts has diverged from that of the ECJ. 60

Section 1516 and its counterpart in other countries thus have different interpretations that place varying levels of importance upon the registered office presumption. Noteworthy is that there are three authors of the Model Law—Judge Lifland, Professor Westbrook, and Daniel Glosband—advocating for limited emphasis on the presumption.

The entire presumption discussion is good fodder for debate, but somewhat overstated in importance. While some will disagree as to whether judges should undertake sua sponte inquiries to rebut the presumption, if any party in interest opposes recognition and presents evidence or proof negating the presumption, a full COMI analysis will be necessary. As this paper argues, the issue is that any full-blown COMI inquiry—whether a United States interpretation of Chapter 15 or a foreign interpretation

58 Id. at 48.
59 Id. at 40.
of a form of the Model Law—will keep offshore funds with typical structures as seen in *SPhinX* and *Bear Stearns* out of United States courts.

Courts should look to foreign cases and their interpretation with respect to terms found in the Model Law. In light of its “international origin,” Chapter 15 directs courts to look outside of the United States in interpreting the Model Law.

The *Bear Stearns* court did look to international law in citing the go-to case that European courts look to in defining COMI. The oft-cited international case is *In re Eurofood IFSC Ltd.* *Eurofood* defines a debtor’s COMI as “the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.” But the *Bear Stearns* court then equated that terminology to the familiar “principal place of business” concepts of United States law. Principal place of business, however, is not language found in Chapter 15 or in the Model Law. Judge Gropper in *In Re Millennium Global Emerging Credit Master Fund Ltd.*, made this observation, and cited *Tri-Continental* and Professor Westbrook, noting, “a crucial jurisdictional test should be uniform.” Judge Gropper then found that in many cases a principal place of business test does not work because a liquidating debtor has no principal place of business, and that “the drafters of the Model Law would not have

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61 See, e.g., *Bear Stearns I*, 374 B.R. at 129.
63 *Bear Stearns I*, 374 B.R. at 129.
65 Id. at 18-19.
employed the [Principal Place of Business] term…because reorganization is rare in most countries outside of the United States.”

One year prior to Judge Lifland’s decision in Bear Stearns was Judge Drain’s decision in SPhinX. The facts of SPhinX are nearly identical to those in Bear Stearns; a failed hedge fund in the Cayman Islands with practically all of its operations located in the United States became insolvent. The debtors sought main recognition, and the court was “inclined to find the Debtors’ COMI in the Cayman Islands and recognize the proceedings as foreign main proceedings.” The court reasoned that the COMI registered office presumption was included for speed and convenience, and that the presumption should be honored when most parties were in favor of the approach. The SPhinX court outlined several factors that presume the COMI to be the location of the debtor’s (i) headquarters, (ii) managers, (iii) primary assets, and (iv) majority of creditors, and the jurisdiction whose law would predominantly apply. While these “SPhinX factors” have become widely adopted (they were approvingly cited in Bear Stearns), the core reasoning of the case has not.

In the end, the court declined to grant main recognition because the debtors sought such recognition for an improper purpose. Somewhat ironic is that all that remains of SPhinX are the SPhinX factors, and the very court that created these factors chose not to apply them in reaching its conclusion. It is notable that if not for the improper purpose, the SPhinX court would have granted main recognition.

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68 Id. at 73.
69 SPhinX I, 351 B.R. at 121.
70 Id. at 117 & 121.
71 Id. at 117.
72 Bear Stearns I, 374 B.R. at 129.
Notwithstanding a total lack of evidence demonstrating any establishment of the fund on the Cayman Islands, the court granted non-main recognition as a fallback. On appeal at the district court level, Judge Sweet agreed with the Bankruptcy Court’s logic.\textsuperscript{73} Thus, on a nearly identical set of facts, the same judge upheld two distinct interpretations (\textit{SPhinX} and \textit{Bear Stearns}) of the recognition provisions. Noting the opinions are “at odds,” Judge Sweet hints that he would follow \textit{Bear Stearns} reasoning in the future.\textsuperscript{74}

Case law continues to evolve regarding COMI, but the takeaway is that offshore funds will often fail in an attempt at recognition as foreign main proceedings. This is because their assets, operations, and management decisions related thereto are almost always located in a country other than their country of incorporation; their COMI is clearly elsewhere. When a foreign representative is unable to obtain recognition as a main proceeding, he will alternatively seek nonmain recognition, which requires an establishment.

\section*{IV. Establishment}

Unlike COMI, establishment is defined in Chapter 15. The term is more straightforward, and has not been the subject of much controversy. A debtor has an establishment in “any place of operations where the debtor carries out a nontransitory economic activity.” Courts have likened it to any place where the debtor has a place of business.\textsuperscript{75} Unlike the registered office presumption in a COMI analysis, there is no

\textsuperscript{73} \textit{In re SPhinX, Ltd. (SPhinX II)}, 371 B.R. 10 (2007 S.D.N.Y.).
\textsuperscript{74} \textit{In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (Bear Stearns II)}, 389 B.R. 325, 334 (S.D.N.Y. 2011).
\textsuperscript{75} \textit{Bear Stearns I}, 374 B.R. at 131.
statutory presumption favoring the finding of an establishment. Courts have required a “showing of a local effect on the marketplace, more than mere incorporation and recordkeeping and more than just the maintenance of property.” Although the idea has been argued and given some consideration, the presence of a bankruptcy proceeding itself does not give way to the finding of an establishment.

Although the SPhinX courts (bankruptcy court and S.D.N.Y.) granted nonmain recognition, they did not delve into an analysis of whether the debtor had an establishment in the Cayman Islands. The bankruptcy court (and the affirmance) treated nonmain recognition as a sort of “pragmatic” fallback when main recognition was inappropriate. As Judge Sweet noted in Bear Stearns II, his affirmance in SPhinX was made in the interest of “flexibility.” Daniel Glosband, another co-author of the Model Law, heavily criticized this methodology, responding that there is no “flexible approach to recognition. The perceived flexibility leads the court to wander from the narrow path to recognition.” Glosband’s reaction to the SPhinX decision is interesting because there is clear support for nonrecognition, and thus for denial of access to United States courts. There is mention of “great harm to the future of Chapter 15” if SPhinX survives, but no solution for the lack of proper forum with respect to the fund’s assets located in the United States. Glosband further notes that SPhinX can file for Chapter 7 liquidation to

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76 Bear Stearns II, 389 B.R. at 338.
78 In re Ran, 607 F.3d 1017, 1028 (5th Cir. 2010).
79 See SPhinX II, 371 B.R. at 18-19; SPhinX I, 351 B.R. at 122.
80 Bear Stearns II, 389 B.R. at 334.
82 Id.
administer those United States assets,\textsuperscript{83} but as we have seen, that statement overlooks the apparent statutory bar against such a filing without recognition.

Judge Lifland also parted with \textit{SPhinX}’s approach; the \textit{Bear Stearns} court undertook an analysis of whether the fund in that case had an establishment on the Cayman Islands. Acknowledging the illegality under Cayman Islands law for the fund to engage in business on the Cayman Islands, the court found it nearly impossible for the debtor to have a place of business there. Although the fund had assets of $15 million in the country of the foreign proceeding, such assets did not rise to the level of any establishment. First, the monies were moved to the Cayman Islands \textit{after} the proceedings began.\textsuperscript{84} Second, the court noted that a “presence of assets” test had been rejected as a definition of establishment in the drafting of the Model Law.\textsuperscript{85}

This paper cites three Model Law drafters, and unsurprisingly, three written positions on the establishment/nonmain topic. Addressing the facts of \textit{SPhinX}, Professor Westbrook found that although the fund’s COMI was in the United States, such a “finding would have made the Cayman proceeding non-main.”\textsuperscript{86} In most of his published writing, the professor does not actually consider or discuss nonrecognition.

With the idea that offshore funds typically cannot establish a COMI or establishment as of the commencement of their foreign proceedings, courts have looked at the various points along a debtor’s bankruptcy timeline in order to grant recognition.

\begin{itemize}
  \item \textsuperscript{83} \textit{Id.} n.26.
  \item \textsuperscript{84} \textit{Bear Stearns I}, 374 B.R. at 131.
  \item \textsuperscript{85} \textit{Id.} at 131 n.12.
  \item \textsuperscript{86} Westbrook, \textit{Locating the Eye, supra} note 24, at 1025.
\end{itemize}
V. **THE TIMING WRinkle**

Courts have struggled in defining the time at which a debtor’s recognition analysis should take place. On one end of the spectrum is an analysis of the debtor at the time its foreign representative filed an initial liquidation or reorganization proceeding, and on the other end is the time such foreign representative filed for recognition.

The case of *Lavie v. Ran*, a Fifth Circuit decision, leans towards conducting a recognition analysis as of the date the petition for recognition is filed. The court states with respect to the definitions section of Chapter 15, “the grammatical tense in which it is written provides guidance to the court. Every operative verb is written in the present or progressive tense.”

The court further states, “Congress’s choice to use the present tense requires courts to view the determination in the present, i.e. at the time the petition for recognition was filed.”

The outcome in *Ran* is not so unsettling from a public policy standpoint; it addressed the case of an individual debtor who relocated from Israel to the United States nearly ten years before a recognition petition with respect to his Israeli bankruptcy proceeding was filed. The court appeared sympathetic towards the debtor, emphasizing that he had lived in the United States for such a long time before the petition was filed there.

While the court chose to use the date the petition for recognition was filed, it added a caveat, stating “[a] similar case brought immediately after the party’s arrival in

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87 *In re Ran*, 607 F.3d 1017, 1025 (5th Cir. 2010).
88 *Id.*
89 *Id.* at 1019.
the United States following a long period of domicile in the country where the bankruptcy is pending would likely lead to a different result.”\textsuperscript{90} The court went to great lengths to provide statutory backup for its position of determining recognition strictly as of the petition date, yet a few paragraphs later acknowledged that it would be willing, under certain circumstances, to look to the period before the filing of the petition for recognition. In other words, had the debtor moved to the United States after living in Israel for ten years, and a petition for recognition of his Israeli bankruptcy proceeding was filed shortly after his arrival, the \textit{Ran} court would be open to granting such recognition. The inconsistency is this: notwithstanding the debtor’s recent arrival, one should, applying the \textit{Ran} logic, conclude that the debtor’s new COMI is in the United States—after all, he lives there—and further that the debtor has no establishment in Israel. This outcome is because the debtor could have very well severed all ties with Israel. While the \textit{Ran} court explicitly said that such a conclusion would likely not be reached, its analysis leading to nonrecognition says otherwise.

Shortly after the decision in \textit{Ran}, the \textit{Fairfield Sentry} court undertook a recognition analysis of a British Virgin Islands (“BVI”) fund that was used as a vehicle for investment with Bernard Madoff.\textsuperscript{91} The fund appointed a BVI liquidator in July of 2009. Approximately 11 months after the fund began liquidation proceedings, the foreign representative filed for Chapter 15 recognition. In the months leading up to the commencement of the liquidation proceeding, the court found that the fund’s activities became connected mainly with a winding up; as such, the fund’s COMI had shifted to

\textsuperscript{90} \textit{Id.} at 1026.
\textsuperscript{91} \textit{In re Fairfield Sentry Ltd. (Fairfield Sentry I)}, 440 B.R. 60 (Bankr. S.D.N.Y. 2010), \textit{aff’d} 2011 WL 4357421 (S.D.N.Y. Sept. 16, 2011).
BVI. Because “the Debtors' activities for an extended period of time [had] been conducted only in connection with winding up the Debtors' business,” the court granted main recognition.92 Expanding upon Ran, the Fairfield Sentry court found the need for a “broader temporal [] assessment” and advocated a “totality of circumstances” approach.93 By doing so, the court avoided the hypothetical debtor that moves immediately before the filing of a petition for recognition, as discussed supra. On appeal, the Southern District of New York affirmed, stating that the “Bankruptcy Court appropriately considered the time at and around Sentry’s Chapter 15 filing.”94

Departing from Sentry and Ran reasoning, the Millennium Global court held that the proper date for conducting a recognition analysis is “on or about the date of the commencement of the foreign proceeding for which recognition is sought.”95 The court explained that the date a petition for recognition is filed “is a matter of happenstance.”96 Further, once a business begins liquidating, it no longer has a place of business, so it is “obvious that the date for determining an entity’s place of business refers to the business of the entity before it was placed into liquidation.”97 Acknowledging the facts of Ran, the Millennium Global court noted that a debtor in such a situation—one where recognition to his foreign proceeding is granted nearly a decade after he relocates—could claim the defense of laches.98

92 Id. at 64.
93 Id. at 66.
94 In re Fairfield Sentry Limited (Fairfield Sentry II), 2011 WL 4357421, at *6 (S.D.N.Y. Sept. 16, 2011) (emphasis added) (as of this writing, case is on appeal to 2d Cir.).
95 458 B.R. 63, 76 (Bankr. S.D.N.Y. 2011)
96 Id. at 72
97 Id. (emphasis added)
98 Id. at 75-76
The issue of timing is far from settled, with two interpretations emerging from the Bankruptcy Court for the Southern District of New York in the span of only a year. What has become clear is that the earlier a fund moves its operations towards its country of incorporation, the higher the likelihood that it will be recognized.

**VI. SOLUTIONS**

In 2010, Judge Gross of the Bankruptcy Court for the District of Delaware granted main recognition, without objection, to a foreign proceeding premised on a set of facts substantially similar to *Bear Stearns*.99 Perhaps funds will begin to seek recognition in other jurisdictions. Either way, there is no way of knowing that other courts will follow Delaware’s lead; even if they do, once a party in interest raises an objection to recognition, the court will likely make a no-COMI finding when confronted with *Bear Stearns*-like facts.100

Still, nonrecognition in and of itself is not the problem; the fact that certain entities may be constructively deprived of access to United States courts altogether causes pause. As the *Millennium Global* court notes, “any exclusionary rule would be contrary to U.S. interests.”101 This is because denying recognition to foreign proceedings keeps them out of United States courts, and thus “prevent[s] them from pursuing legitimate claims against third parties.”102

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99 *In re Saad Investments Finance Company (No. 5) Limited, Case No. 09-13985 (KG) (Bankr. Del. Feb. 3, 2010)*
100 See discussion of this point in Section III.
101 *In re Millennium Global Emerging Credit Master Fund Ltd., 458 B.R. 63, 81-82 (Bankr. S.D.N.Y. 2011).*
102 *Id.* at 82.
As the foregoing recognition analysis discusses, there are many instances in which an offshore fund will be denied recognition. In most cases, the denial will rest on the basis that such fund’s COMI or establishment is actually in the United States. Once a foreign proceeding is commenced, because of Section 1511, recognition is required for commencement of a Chapter 7 or 11 filing under the Code. To date, reaching the bankruptcy court via this route has involved some modicum of flexibility on the part of the judiciary.

One solution seems to be that creditors could force the fund into involuntary proceedings *first* in the United States. In such a case, there is no foreign proceeding. As the debtor would inevitably have “a place of business, or property in the United States,” it is an eligible debtor.103 The court in *In re Zais Inv. Grade Ltd. VII* was confronted with a fund placed into an involuntary proceeding under Chapter 11 before there was a Chapter 15 filing.104 First, the court acknowledged that the fund was “eligible to be a debtor under Section 109.”105 Then, the court established that “[a] Cayman Islands proceeding would suffer the same infirmities as those in *Bear Stearns,*” meaning had the Zais fund been placed into a Cayman Islands proceeding, it would have been denied recognition and shut out of United States Courts.106 The court acknowledged that there was no other forum to grant relief.107 But what happens if the funds are *then* placed into a foreign proceeding? If foreign law calls for displacement of the fund’s management, who runs

105 Id. at 846.
106 Id.
107 Id. at 847.
the case? The result is a conflict of laws, which is precisely the opposite of the “harmony” that Chapter 15 intends to address.

Assuming a foreign proceeding has already commenced, and further assuming rigidity on the part of the court, options truly dwindle. Congress might want to address these nuanced instances in clear statutory language, providing some form of access of these foreign debtors to United States courts. As the *Bear Stearns* court notes, there is a drafting error with respect to Section 303 and Chapter 15, so a change of some sort is merited.

The Judicial Perspective points out that “some States that have enacted the Model Law do provide additional powers to the courts under other law to assist foreign proceedings that might include types of proceedings not subject to recognition under the Model Law.” One commentator proposes adopting Canada’s approach to the Model Law, which is to recognize a foreign proceeding at minimum as a nonmain proceeding. As the article cites, Canada “does not require an establishment in order to recognize foreign non-main proceedings.” Providing nonmain recognition as a minimum seems reasonable, because there is no automatic applicability of the protections of the Code. Under this scenario, a judge is granted discretion to invoke specific available sections of the Code based on the facts and circumstances of each case.

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108 *Bear Stearns I*, 374 B.R. at 132 n.15.
109 Judicial Perspective, *supra* note 21, at ¶ 44.
111 *Id.* (quoting Andrew Kent, et. al., UNCITRAL, eh? The Model Law and Its Implications for Canadian Stakeholders, in 2005 *ANNUAL REV. OF INSOLVENCY LAW* 2005 at 187 (2006)).
Until recently, Professor Westbrook has not discussed nonrecognition. In celebrating the arrival of Chapter 15, the professor notes the significance of reversing *In re National Warranty Insurance Risk Retention Group*, which involved a Cayman Islands company selling extended warranties in the United States. Because the company’s management brought all assets to the Cayman Islands immediately before commencement of the foreign proceeding, the proceeding went forward on the Cayman Islands. And although prior to the foreign filing the debtor maintained no assets on the Cayman Islands, Professor Westbrook writes the “case would have been a nonmain proceeding entitled to limited recognition at best.” But nonmain recognition is a fine starting point. A main reason why Chapter 15 was adopted was to bring cases like *National Warranty*—cases that required the assistance of United States courts—before United States courts, and not to shut them out. It is important is that parties are not completely kept out of the precise forum that is best able to help administer and distribute an insolvent debtor’s assets.

There is some irony in the *Bear Stearns* approach to recognition under Chapter 15. Any debtor is eligible to file a full-fledged plenary case in the United States so long as the debtor has property there. A bank account, even one with $194 in it, is good enough. This is not to say that bankruptcy courts are overreaching; proceedings such

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112 See *supra* note 86. Professor Westbrook has, however, expressly confirmed that nonrecognition in *Bear Stearns* was the correct outcome. He does not endorse any implicit fallback to nonmain recognition. E-mail from Jay L. Westbrook, Professor of Law, University of Texas, to author (Apr. 16, 2012, 22:08 EDT) (on file with author).
113 Westbrook, *At Last, supra* note 4, at 727 (discussing 384 F.3d 959 (8th Cir. 2004)).
114 *Id.*
115 *Id.* at 728. Under Chapter 15, the timing issue would have inevitably been central, as the assets were moved to the Cayman Islands before the foreign proceeding commenced.
as this will only go forward with cooperation of the parties in interest. The issue is that the Code will permit the reorganization and liquidation of massive debtors with only token assets in the United States, but on the other hand will not even recognize such a proceeding taking place elsewhere; based on current Chapter 15 jurisprudence, it would be as if the proceeding does not even exist. To date, the drafters of the Model Law have yet to come forward with a recognition solution that is consistent with the Code and that provides access to United States courts.

And so, the problem is this: sophisticated financial entities are formed in a manner that puts them in a Chapter 15 black hole because courts tend to ignore the structures that investors expect and contract for with respect to liquidation.

If and until Congress amends Chapter 15, offshore entities should consider the importance of recognition, and should carefully strategize before commencing liquidation proceedings. Doing so just might ensure access to United States courts.

\[118\] *In re Aerovias Nacionales de Colombia S.A.*, 303 B.R. 1, 13 (Bankr. S.D.N.Y. 2003) (“The fact that many of [the debtor’s] principal creditors are in this country, and the willingness of major [foreign] parties in interest to participate in the proceedings, is one of the most significant factors supporting the filing [in the United States].”).