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Recognition of Offshore Insolvency Proceedings: 'Fairfield Sentry'

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Chapter 15 of the Bankruptcy Code, enacted in 2005, permits a representative designated in a foreign insolvency proceeding to avail itself of the U.S. bankruptcy courts—and of various protections of the U.S. Bankruptcy Code—if the foreign proceeding is "recognized" as a "foreign main" or "foreign nonmain" proceeding. Over the years, there has been significant litigation regarding the application of this statute to hedge funds managed out of New York but incorporated in offshore jurisdictions. In particular, bankruptcy courts in the Southern District of New York have grappled with the question of whether liquidation proceedings filed by hedge funds in Caribbean "havens" should be recognized, despite the debtors' U.S. origins and management.

The Second Circuit's recent decision in ***Fairfield Sentry***,[1] which recognized the British Virgin Islands liquidation of a large Madoff feeder fund as a "foreign main proceeding," substantially clarifies the standard for recognition under Chapter 15, providing comfort that New York courts are not closed to offshore funds that choose to liquidate in their places of incorporation. At the same time, the test endorsed by the Second Circuit, which turns on the debtor's activities as of its Chapter 15 petition, leaves the door open for future litigation in situations where the debtor has not undergone the kind of broad "migration" from the United States experienced by Fairfield Sentry following Madoff's historic collapse.

THE 'COMI' CONCEPT

Chapter 15 of the Bankruptcy Code was designed to facilitate cooperation by U.S. courts in connection with foreign insolvency proceedings. Under the statute, the representative of a foreign debtor is afforded broad relief, including an automatic stay as to U.S. property and the right to file a voluntary U.S., bankruptcy case, if a foreign proceeding is recognized as a "foreign main proceeding."[2] A foreign representative may also obtain relief following recognition of a "foreign nonmain proceeding," but such relief is discretionary and more limited.[3]

Chapter 15 requires a bankruptcy court to recognize a foreign insolvency proceeding as a "foreign main proceeding" if it is "pending in the country where the debtor has the center of its main interests," often referred to as the debtor's "COMI." By contrast, a foreign proceeding must be recognized as a "foreign nonmain proceeding" if it is not a "main proceeding" but is "pending in a country where the debtor has anestablishment."[4] The statute also includes an overriding public policy exception, which permits the court to refuse to take action that is "manifestly contrary to the public policy of the United States."[5]

Chapter 15 establishes a presumption that a debtor's "registered office" is its COMI.[6] However, the statute does not otherwise define COMI, nor does the statute make clear as of when the debtor's COMI should be evaluated. In particular, it does not state explicitly whether a court should focus on: (a) the debtor's operations prior to its insolvency; (b) its activities at the time of the commencement of its foreign liquidation; or (c) its activities as of the filing of the Chapter 15 petition.

HEDGE FUND PRECEDENTS

Since 2007, Chapter 15 practice in the Southern District has been heavily influenced by the decision of Bankruptcy Judge Burton Lifland to deny an uncontested application for recognition of Cayman Islands proceedings commenced by two Bear Stearns hedge funds.[7] In *Bear Stearns*, Lifland concluded that, despite the funds' registered office being in the Cayman Islands, the funds lacked any meaningful connection to the Caymans: the funds were managed out of New York, their liquid assets were in the United States, and their investors were in the United States or Europe.

The court also concluded that the funds had no "establishment" (i.e. "local place of business") in the Cayman Islands that would support recognition of the Cayman proceedings as nonmain proceedings because they were essentially "mail drops"

organized under a provision of Cayman law that prohibited the funds from operating a business in the Cayman Islands. In denying recognition, Lifland—a noted expert on cross-border insolvency law—departed from a decision in another hedge-fund case, *Sphinx*, in which Bankruptcy Judge Robert Drain recognized a Cayman liquidation as a nonmain proceeding despite a similar absence of Cayman contacts.[8]

Following *Bear Stearns*, there have been relatively few decisions in New York recognizing offshore liquidation proceedings filed by investment funds. One exception is *Millennium Global*, in which Bankruptcy Judge Allan Gropper concluded that Bermuda liquidation proceedings filed by two Bermuda-incorporated funds should be recognized as foreign main proceedings.[9] Unlike in *Bear Stearns*, the funds at issue in *Millennium Global* had "extensive contacts" with their place of incorporation (Bermuda); two of their directors resided there, as did their bank and administrator.[10]

In *Millennium Global*, the parties objecting to recognition argued that London, rather than Bermuda, was the debtor's COMI based on the location of its investment manager and creditors. In rejecting this argument, Gropper held, among other things, that the funds' COMI should be determined as of the filing of the foreign proceeding—not as of the subsequent Chapter 15 petition. The court reasoned that "if the term 'principal place of business' is substituted for 'center of main interests,' 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" because "[a] debtor does not continue to have a principal place of business after liquidation is ordered and the business stops operating."[11]

The court's rationale was persuasive, but could be questioned for focusing its recognition analysis on a proceeding that had not yet been recognized. In addition, the *Millennium Global* court departed as to timing from three out-of-circuit decisions holding that a debtor's COMI should be determined based on circumstances as of the time of its Chapter 15 petition.[12] Notably, the court also departed from the bankruptcy court's decision in *Fairfield Sentry*, discussed below.

'FAIRFIELD SENTRY'

Fairfield Sentry Ltd., although incorporated in the British Virgin Islands, was managed out of New York and existed for the purpose of investing with Bernard Madoff's New York-based brokerage firm. After Madoff's arrest in December 2008, however, Sentry significantly scaled back its activities in New York. Operating under the control of directors based in Europe, Sentry prepared for litigation arising out of the Madoff scandal and, in July 2009, Sentry was itself placed into liquidation in the BVI.

In June 2010, Sentry's BVI-based liquidators filed a petition for recognition of the BVI proceeding in New York. Over the objection of a Sentry shareholder that had filed a

derivative action on Sentry's behalf in New York, Judge Lifland (the same judge who decided *Bear Stearns*) issued an order recognizing the BVI proceeding as a "foreign main proceeding."[13] In granting the Chapter 15 petition, Lifland concluded that the debtor's COMI should be determined based on the facts existing at the time of the Chapter 15 petition, provided that the debtor had not engaged in "mischief and COMI manipulation." The court found that Sentry, rather than manipulating its COMI, had discontinued its New York-based activities following Madoff's arrest and consolidated its activities in the BVI over a sustained period.[14]

On appeal to the U.S. Court of Appeals for the Second Circuit, the shareholders argued that: (1) Sentry's COMI was in New York, the place it invested, had been managed, and continued to hold intangible assets including claims against the Madoff estate; and (2) the BVI proceeding violated U.S. public policy because it did not provide for public access

The Second Circuit rejected both arguments. Like the bankruptcy court, and in contrast to *Millennium Global*, the court concluded first that a debtor's COMI is determined as of its chapter 15 petition, absent evidence of bad-faith manipulation. The court based this conclusion in part on the present-tense language in the definition of "foreign main proceeding"—i.e., a proceeding that "is" pending where the debtor "has" its COMI.[15] The court then went on to review a variety of factors, including the location of the debtor's headquarters, managers, and primary assets to conclude that Sentry had its main interests in the BVI at the time of its Chapter 15 petition.[16]

The Second Circuit also concluded that the confidentiality of the BVI proceeding was not a basis to deny recognition. The court noted that, while BVI proceedings are sealed, public summaries are provided and non-parties can apply for access to court documents. The court also held that the lack of public access "does not offend U.S. public policy," since access to court documents is a "qualified right" under U.S. law rather than "an exceptional and fundamental value."[17]

IMPLICATIONS

The Second Circuit's decision in *Fairfield Sentry* is significant in light of its unequivocal holding that, absent bad-faith manipulation, a debtor's COMI is evaluated as of its Chapter 15 petition. The decision resolves the split among courts in the Southern District of New York as to the relevant time frame for the COMI analysis, and also makes clear that a court may consider a range of factors in determining a COMI, including the activities of foreign liquidators following their appointment. In addition, the decision makes clear that the "public policy" exception in the statute will be construed narrowly, such that New York bankruptcy courts will invoke the exception only in egregious situations.

Fairfield Sentry is of special importance to the investment management industry. Following *Bear Stearns*, there was cause to question whether New York City—the center of the U.S. investment industry—would essentially be closed to foreign liquidators of funds originally managed out of New York. *Fairfield Sentry* largely puts those concerns to rest, at least in situations where a foreign fund (or its liquidators) can consolidate the funds' activities in its "home" jurisdiction following an insolvency but before filing a Chapter 15 petition.

At the same time, *Fairfield Sentry* may in some respects be sui generis. As a result of Madoff's collapse, Sentry's assets and operations changed dramatically in December 2008. Following that event, the New York-based managers of Sentry were disassociated from the fund, and the fund's "business" shifted immediately from investing to managing litigation. In those unusual circumstances, Sentry had little difficulty moving its interests (aside from intangible assets) away from the United States and into the control of a BVI-based liquidator.

It is questionable whether other debtors, and in particular hedge funds, will find it desirable or even possible to "migrate" from the United States in similar fashion. Some funds may need Chapter 15 relief without the delay attendant to consolidating abroad. Other funds may need the continued assistance of their U.S. managers as they wind down assets that the manager chose.

Finally, while the unusual circumstances of Sentry's liquidation made it difficult to claim that it had "manipulated" its COMI, the Second Circuit's warning about "manipulation" will almost certainly be invoked by objectors to recognition in future cases. In sum, it is yet to be seen how the Second Circuit's decision in *Fairfield Sentry* will translate in cases where a fund does not experience the kind of drastic change in profile that Sentry experienced when it learned that its New York-based assets had effectively disappeared.

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Endnotes:

1. ***Morning Mist Holdings v. Krys*** (*In re Fairfield Sentry*), No. 11-4376, 2013 U.S. App. LEXIS 7608 (2d Cir. April 16, 2013).

2. See 11 U.S.C. §§1520, 1511(a)(2).

3. See 11 U.S.C. §1521.

4. See 11 U.S.C. §1517(b).

5. See 11 U.S.C. §1506.

6. See 11 U.S.C. §1516(c).

7. ***In re Bear Stearns High-Grade Structured Credit Strategies Master Fund***, 374 B.R. 122 (Bankr. S.D.N.Y.2007), aff'd, 389 B.R. 325 (S.D.N.Y. 2008).

8. ***In re SPhinX***, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), aff'd, 371 B.R. 10 (S.D.N.Y. 2007).

9. ***In re Millennium Global Emerging Credit Master Fund***, 458 B.R. 63 (Bankr. S.D.N.Y. 2011)), aff'd 474 B.R. 88 (S.D.N.Y. 2012).

10. *Millenium Global*, 458 B.R. at 80.

11. *Millenium Global*, 458 B.R. at 71-72.

12. See *In re Ran*, 607 F.3d 1017 (5th Cir. 2010); *In re Betcorp*, 400 B.R. 266 (Bankr. D. Nev. 2009) *In re British Ame. Ins. Co.*, 425 B.R. 884 (Bankr. S.D. Fla. 2010)

13. *In re Fairfield Sentry*, 440 B.R. 60 (Bankr. S.D.N.Y. 2010), aff'd, No. 10 Civ. 7311 , 2011 WL 4357421, at *1 (S.D.N.Y. Sept. 16, 2011).

14. *In re Fairfield Sentry*, 440 B.R. at 65-66.