The lessons of Philadelphia, Sphinx and Refco

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Ken Krys of RSM Cayman Islands analyses the lessons these big cases have to teach on how to liquidate offshore funds. For instance, can the US extend its jurisdiction into Cayman?

In theory, winding up a hedge fund that is registered offshore should be simple. Recent cases which my firm has been involved with demonstrate it is anything but.

The liquidators are obligated under Cayman Islands law, among other things, to maximise the realisations of the estate's assets; identify the companies' creditors and the amounts of their claims; and distribute the proceeds of the realisation of the companies' assets to the companies' creditors and, thereafter, to shareholders.

Included in this obligation is a duty to investigate the fund's affairs, with a view to assessing whether there are potential asset recoveries that benefit the estate, its creditors and shareholders.

What happens in practice is rarely as easy as it appears in theory.

Increasingly, we are finding that where assets, documents, and people involved are outside of the jurisdiction, major issues and difficulties can arise.

Philadelphia freedom

Issues can arise as to governing law. This can happen where offshore funds have operations in the United States, and particularly where a US Receiver has been appointed in the US.

In May 2006, the Grand Court of the Cayman Islands considered this particular situation in the case of Philadelphia Alternative Asset Fund Limited (PAAF).

An American receiver, appointed in 2005 by the US Commodity Futures Trading Commission (CFTC), attempted to be appointed liquidator of a Cayman Islands incorporated fund regulated in the Cayman Islands.

The US receiver tried to argue that the liquidation in Cayman served no practical purpose. He said that it would be a duplication of costs and effort, as the receiver had already been recovering assets and was taking other steps to wind up the fund in the US.

The American receiver also argued that any distributions would be made in accordance with Cayman law, as the application of US law would have caused prejudice to investors of the Cayman fund.

The application was opposed by certain investors who sought to have a Cayman Islands insolvency practitioner appointed.

The Grand Court decided that the liquidators should be the Cayman Islands practitioners. It based this decision on the fundamental legal principle that when a company is incorporated in the Cayman Islands, Cayman law will apply to its liquidation and the best person to wind up a Cayman fund knowledgeable of Cayman law, would be a Cayman practitioner.

This is not to say that the Cayman Courts have no flexibility in certain cases. The Courts have in the past granted joint appointments between a Cayman practitioner and a foreign liquidator.

The judge in the matter added that investors had a reasonable and legitimate expectation that such a winding up would occur in the Cayman Islands under Cayman law.

Recognition of a foreign liquidator in the US

Compare that to the situation where a Cayman resident liquidator has been appointed in the Cayman Islands and now needs to seek recognition in the US in order that his powers are available there.

Chapter 15 is a new chapter added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

It is the US domestic adoption of the Model Law on Cross-Border Insolvency promulgate by the United Nations Commission o International Trade Law (UNCITRAL) in 1997.

Chapter 15 replaces section 304 of th Bankruptcy Code.

Because of the UNCITRAL source fo Chapter 15, the US interpretation is suppose to be coordinated with the interpretatio given by other countries that have adopted i as internal law, to promote a uniform an coordinated legal regime for cross-borde insolvency cases.

The purpose of Chapter 15, and the Mode Law on which it is based, is to provid effective mechanisms for dealing with cross border insolvency cases involving funds assets, claimants and other parties in interes involving more than one country. Generally, a Chapter 15 case is ancillary to a primar proceeding brought in another country typically the debtor's home country.

An ancillary case is commenced under Chapter 15 by a 'foreign representative' filing a petition for recognition of a 'foreign proceeding'.

Through the recognition process, Chapter 15 operates as the principle door of a foreign representative to the federal and state courts of the US.

When Section 304 of the Bankruptcy Code was in place, the US Bankruptcy Courts often saw applications from court-appointed Cayman liquidators and recognised them.

Given that the purpose and spirit of Chapter 15 was to promote a uniform and coordinated legal regime for cross-border insolvency cases, recognition of a court-appointed Cayman liquidator under Chapter 15 should be relatively procedural.

But it's not always that easy.

The SPhinX Funds

We recently sought such recognition in relation to our role as court-supervised liquidators of the SPhinX Funds.

The SPhinX Funds are a group of investment vehicles that were designed to track certain Standard & Poor's hedge fund indexes.

Each of the SPhinX Funds was organised and incorporated under the laws of the Cayman Islands and the liquidators were subject to the supervision of the Grand Court of the Cayman Islands.

The liquidator of the SPhinX Funds applied for foreign recognition under Chapter 15 in the United States Bankruptcy Court for the Southern District of New York.

He did this, among others things, to:

- protect the SPhinX Funds' US$500 million in assets located in the United States
- obtain an automatic stay of litigation
- commence and prosecute litigations in the United States
- pursue discovery in the United States in order to evaluate the merits of various litigations to be pursued in and outside the United States
- obtain turnover of the SPhinX Funds' assets and properties in the possession of third parties, including, but not limited to, the SPhinX Funds' documents and records

Centre of Main Interest

Often such an application would be heard ex-parte. In this case, notice was given to certain parties who were involved in a settlement involving the SPhinX Funds and Refco (the bankrupt securities trader) who may be impacted by the stays available if the liquidators were recognised.

The persons involved in the settlement filed a joint objection to the recognition of the Cayman proceedings as foreign main proceedings.

This was the first time an application for recognition under Chapter 15 was challenged.

The primary issue in the hearing was twofold: COMI (Centre of Main Interest); and the US Bankruptcy Court's discretion to consider other factors.

The liquidators listed a number of factors which they suggested supported their contention that the Cayman Islands was the COMI.

While there were also factors that connected the SPhinX Funds to the United States, the US Bankruptcy Court said that, had there been no factors, it would have given the liquidation proceedings in the Cayman Islands foreign recognition.

The Court also considered what it described as the intentions of the liquidators, and the impact that the recognition under Chapter 15 may have on the settlement.

The US Bankruptcy Court suggested that the liquidators had made the application to put a stay on the settlement discussed above.

Given the impact that this may have on the Refco objectors, it concluded that liquidators were acting improperly.

On this basis, it concluded that the proceeding should be recognised as foreign non-main, thereby giving the liquidators none of the deemed relief afforded under Chapter 15.

The liquidators are appealing the decision because they believe the decision erred in fact and in law.

They also have concerns that the judge who heard the application was the same judge who had overseen and approved the settlement, which seemed to be a major factor in the decision.

Segregated portfolio cells (SPCs)

Another issue that we foresee being addressed in the Cayman Courts this year is the legal interpretation and impact in a liquidation of segregated portfolio cells, or SPCs.

An SPC is a company that allows for the creation of one or more cells in order to effectively 'ring fence' the pools of assets and liabilities within the company.

The use of SPCs was initially used predominately by the captive insurance market.

In recent years the use of SPCs has expanded. This structure is now used in the development of mutual funds, securitisation, and structured finance industries.

An SPC can establish any number of cells and issue different classes of shares for each such cell. This insures that the assets and liabilities within the segregated portfolio are protected from the other portfolios.

The segregated portfolio does not constitute a legal entity separate from the SPC.

In the case of the SPhinX Fund, a number of important issues have come to light that will require Court direction. They are:

- Is the test for solvency based on cash flow, balance sheet, or a combination of both?
- Can a portfolio have its own solvency test, as compared to the company? If insolvent, can the portfolio pursue preference claims and other remedies available for an insolvent company?
- Whilst one cell may be insolvent, another, or the company as a whole, may not. In other words, can a cell, as opposed to the company itself, seek remedies?
- Where a cell is insolvent, what impact does this have on the company?
- While other cells may be protected, does the company assume responsibility for the remaining debt?
- What is the impact on creditors and investors? In the case where there are indemnities granted by the company, if there are insufficient general pools of assets, does the contingent creditor have a right to pursue each cell? If so, what portion of the liability is the cell responsible for?

  Presumably pro rata. However, this would be for a Court to decide.
- What is the impact of inter-portfolio transactions? The rationale of having portfolio cells is to 'ring fence' the pools of assets and liabilities within a portfolio.

  But is the ring fence affected when a portfolio collects assets or pays liabilities on behalf of another?
- Where a particular portfolio doesn't have sufficient assets to meet its liabilities as they fall due, what impact is there when the directors in effect borrow from another cell to cover the cell's debts? Could this affect the integrity of the SPC?

Conclusion

To date, the segregated portfolio regime has not been tested in the Cayman Islands or in any other Court. We are still investigating how these issues will be addressed. It is our intention to seek direction of the Court on these issues. The decisions reached will have a significant impact on how these structures are used in the future.