



Chapter 15 Recognition Denied Due to COMI Manipulation Scheme to Evade UK Judgment

More than a decade after the enactment of chapter 15 of the Bankruptcy Code, issues pertaining to recognition of a foreign debtor's bankruptcy or insolvency proceeding under chapter 15 have, in large part, shifted from the purely procedural inquiry (such as the foreign debtor's center of main interests, or "COMI") to more substantive challenges regarding the limits, if any, that chapter 15 places on U.S. bankruptcy courts. But as demonstrated by the recent ruling in *In re Creative Finance Ltd. (In Liquidation)*, 2016 BL 8825 (Bankr. S.D.N.Y. Jan. 13, 2016), U.S. bankruptcy courts continue to closely scrutinize the manner and place of the foreign insolvency proceeding to ensure that it complies with the prerequisites for recognition under chapter 15. In *Creative Finance*, the U.S. Bankruptcy Court for the Southern District of New York denied recognition of a British Virgin Islands ("BVI") liquidation commenced as part of a scheme to avoid paying a UK judgment. The court ruled that the debtors' foreign representative failed to demonstrate that the debtors' COMI was in the BVI—either at the time of the filing of the liquidation or because of the liquidator's post-filing activities—or even that the debtors had an establishment in the BVI. Moreover, in so ruling, the court emphasized that "[f]rom beginning to end, ... [the] tactics [of the debtors' principal] were a paradigmatic example of

bad faith, and the [BVI] Liquidator's actions—and inaction—facilitated them."

Procedures and Recognition Under Chapter 15

Under chapter 15, the representative of a foreign debtor may file in a U.S. bankruptcy court a petition seeking "recognition" of a "foreign proceeding." "Foreign representative" is defined in section 101(24) of the Bankruptcy Code as "a person or body, including a person or body appointed on an interim basis, 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."

"Foreign proceeding" is defined in section 101(23) of the Bankruptcy Code as:

[A] collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

More than one bankruptcy or insolvency proceeding may be pending with respect to the same foreign debtor in different countries. Chapter 15 therefore contemplates recognition in the U.S. of both a “main” proceeding—a case pending in the country where the debtor’s COMI is located—and “nonmain” proceedings, which may have been commenced in countries where the debtor merely has an “establishment.”

Section 1517 of the Bankruptcy Code provides that, subject to section 1506, after notice and a hearing, “an order recognizing a foreign proceeding shall be entered” if the proceeding qualifies as a foreign main or nonmain proceeding, the foreign representative is “a person or body,” and the petition itself complies with the evidentiary requirements set forth in section 1515. Section 1506 states that “[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States.”

If a U.S. bankruptcy court recognizes a foreign main proceeding under chapter 15, section 1520(a)(1) of the Bankruptcy Code provides that actions against the foreign debtor or “property of the debtor that is within the territorial jurisdiction of the United States” are stayed under section 362 the Bankruptcy Code’s “automatic stay.”

Following recognition of a foreign main or nonmain proceeding, section 1507 states that the bankruptcy court may also provide “additional assistance” to a foreign representative. This can include injunctive relief or authority to distribute the proceeds of all or part of the debtor’s U.S. assets. However, under section 1507(b), in granting such relief, the court must consider, “consistent with the principles of comity,” whether such assistance will reasonably ensure, among other things, the just treatment of creditors and other stakeholders, the protection of U.S. creditors against prejudice and inconvenience in pursuing their claims in the foreign proceeding, and the prevention of fraudulent or preferential dispositions of the debtor’s property.

Foreign Main Proceeding—Center of Main Interests. The Bankruptcy Code does not define “center of main interests.” However, section 1516(c) provides that, “[i]n the absence of evidence to the contrary, the debtor’s registered office, or habitual residence in the case of an individual, is presumed to be” the debtor’s COMI.

Various factors have been deemed relevant by courts in determining a debtor’s COMI, including the location of the debtor’s headquarters, managers, employees, investors, primary assets, or creditors, as well as which jurisdiction’s law would apply to most disputes. See *In re SPHinx, Ltd.*, 351 B.R. 103, 117 (Bankr. S.D.N.Y. 2006), *aff’d*, 371 B.R. 10 (S.D.N.Y. 2007). In addition, courts have considered any relevant activities, including liquidation activities and administrative functions. See *Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127, 137 (2d Cir. 2013). Courts may also consider the situs of the debtor’s “nerve center,” including the location from which the debtor’s “activities are directed and controlled, in determining a debtor’s COMI.” *Id.* at 138. “[R]egularity and ascertainability” by creditors are also important factors in the COMI analysis. *Id.*

In *Fairfield Sentry*, the Second Circuit ruled that the relevant time for assessing COMI is the chapter 15 petition date, rather than the date a foreign insolvency proceeding is commenced with respect to the debtor. The impact of the ruling is that, in cases where a foreign representative engages in significant pre-U.S. chapter 15 filing activities—such as operating or liquidating the debtor—in the jurisdiction where the foreign proceeding was commenced, COMI “can be found to have shifted from the foreign debtor’s original principal place of business to the new locale.” *Creative Finance*, 2016 BL 8825, *31. This can occur even if the activities take place in a “letter-box” jurisdiction where the debtor itself had few contacts and conducted no meaningful business. *Id.* (citing cases).

In *Fairfield Sentry*, the Second Circuit also noted concern about possible COMI “manipulation,” ruling that a court “may look at the period between the commencement of the foreign proceeding and the filing of the Chapter 15 petition to ensure that a debtor has not manipulated its COMI in bad faith.” *Fairfield Sentry*, 714 F.3d at 138.

Foreign Nonmain Proceeding—Establishment. An “establishment” is defined in section 1502(2) as “any place of operations where the debtor carries out a nontransitory economic activity.” Unlike with the determination of COMI, there is no statutory presumption regarding the determination of whether a foreign debtor has an establishment in any particular location. See *In re British Am. Ins. Co.*, 425 B.R. 884, 915 (Bankr. S.D. Fla. 2010). The debtor’s foreign representative

bears the burden of demonstrating that the debtor has an establishment in a particular jurisdiction. *Id.*

Abstention—Section 305. Section 305(a) of the Bankruptcy Code provides that a bankruptcy court can dismiss, or suspend, all proceedings in a bankruptcy case under any chapter if: (i) “the interests of creditors and the debtor would be better served by such dismissal or suspension;” or (ii) the court has granted a petition for recognition of a foreign proceeding under chapter 15, and “the purposes of chapter 15 ... would be best served by such dismissal or suspension.” Abstention under section 305 is with respect to the entire case and “reflects Congress’s recognition that there may be situations where creditors and the debtor would be better served outside of bankruptcy,” such as when recalcitrant creditors involved in an out-of-court restructuring file an involuntary bankruptcy petition to extract more favorable treatment from the debtor. Collier on Bankruptcy ¶ 305.01[1] (16th ed. 2016). Because an order dismissing or suspending all proceedings in a case under section 305(a) may be reviewed on appeal only by a district court or a bankruptcy appellate panel, rather than a court of appeals or the U.S. Supreme Court (see 11 U.S.C. § 305(c)), section 305(a) dismissal is an “extraordinary remedy.” *In re Kennedy*, 504 B.R. 815, 828 (Bankr. S.D. Miss. 2014); see also *Gelb v. United States (In re Gelb)*, 2013 BL 166941, *6 n.13 (B.A.P. 9th Cir. Mar. 29, 2013) (dismissal or suspension order under section 305(a) reviewable by bankruptcy appellate panel).

In *Creative Finance*, the bankruptcy court examined the chapter 15 recognition requirements and challenges to recognition based on the alleged bad faith of a pair of foreign debtors and their principal, as well as a foreign liquidator’s inaction.

Creative Finance

Creative Finance Ltd. and Cosmorex Ltd. (collectively, the “debtors”), each of which was organized under the laws of the BVI, were engaged in foreign exchange trading through accounts provided by third parties, such as Refco Capital Markets (“Refco”). The debtors conducted all or nearly all of their business through foreign exchange brokers located outside the BVI. The debtors’ sole shareholder, Carlos Sevilleja (“Sevilleja”), and their sole director do not reside in the BVI, spending the bulk of their time in Spain or Dubai.

In 2011, Marex Financial Ltd. (“Marex”) sued the debtors in the English High Court of Justice (the “English Court”) for amounts allegedly due under trading contracts after Marex closed out currency positions when the Japanese yen plummeted in the wake of the catastrophic March 2011 tsunami and the ensuing nuclear disaster. The contracts included an English choice of law clause, and all of the underlying transactions that gave rise to the dispute occurred outside the BVI. The debtors’ only physical presence in the BVI was through a registered agent and a post office box.

On July 19, 2013, the English Court circulated a proposed judgment awarding approximately \$5 million to Marex. The draft judgment contained language restraining the parties from taking action in response to the judgment before formal pronouncement, on penalty of contempt of court. The English Court formally handed down the judgment on July 26, 2013, establishing August 8, 2013, as the deadline for the debtors to pay the amount due. The debtors never appealed the judgment.

Instead of paying or appealing the judgment, the debtors, directed by Sevilleja, transferred more than \$9.5 million from their accounts in England to accounts in Gibraltar and Dubai. The transfers occurred after circulation of the draft judgment but before the payment deadline.

After the transfers, the debtors’ only remaining material assets consisted of approximately \$171 million in allowed unsecured claims in Refco’s U.S. chapter 11 case. After the debtors received an interim distribution from the Refco estate in August 2013 in the amount of \$1.7 million, those funds were also withdrawn from the debtors’ English bank accounts.

On August 29, 2013, in an effort to enforce the English Court’s judgment in the U.S. against future Refco claim distributions, Marex—the debtors’ only noninsider creditor—sued the debtors in New York state court. The state court entered judgments against the debtors that domesticated the English Court’s judgment in early November 2013.

On September 16, 2013, Marex applied to the BVI High Court of Justice (the “BVI Court”) to place the debtors into liquidation, but later withdrew the application, citing “cost implications.”

On December 12, 2013, Sevilleja directed that the debtors be put into liquidation in the BVI. The debtors then designated their own liquidator, to whom they provided just enough funding to comply with the minimum requirements of BVI law, but not enough to investigate the debtors' affairs, including pre-insolvency transfers.

On the basis of the domestication judgments, Marex entered into a court-approved stipulation on December 30, 2013, with the Refco trustees and chapter 11 plan administrator, providing that future distributions from the Refco estate in respect of the debtors' claims would be paid directly to Marex.

Even though Marex was notified of the BVI liquidation, it never informed the liquidator that it was negotiating a stipulation affecting the debtors' distributions from the Refco estate. Nor did it apprise the U.S. bankruptcy court of the commencement of the BVI liquidation before submitting the stipulation for approval.

The Refco plan administrator notified the liquidator of the proposed stipulation before it was approved by the U.S. bankruptcy court. However, the liquidator did not file an objection.

On February 10, 2014, the BVI Court approved the liquidator's appointment and authorized the liquidator to file a chapter 15 petition on the debtors' behalf in the U.S. Upon approval of his appointment, the liquidator became the sole manager of the debtors, which by that time had ceased operating. However, the liquidator did nothing to either manage or liquidate the debtors, other than performing minimum functions required by BVI law. These included administrative tasks, providing notice to creditors of the commencement of the liquidation and the claims bar date, convening the initial creditors' meeting, and issuing certain reports. The liquidator never collected or liquidated any of the debtors' assets; investigated the debtors' affairs, including claims against their estates; or asserted any causes of action on behalf of the estates. Except for agreeing to the UK counsel fees component of a claim asserted by Marex, the liquidator did not pay or settle any claims.

The liquidator filed a petition on February 9, 2014, in the U.S. bankruptcy court, seeking recognition of the debtors' BVI

liquidation as a foreign main proceeding under chapter 15 or, alternatively, recognition of the BVI liquidation as a foreign nonmain proceeding. Marex opposed the petition, arguing that recognition should be denied for failure to meet chapter 15's requirements and on public policy grounds, by reason of, among other things, the debtors' bad faith. Marex also sought dismissal of the chapter 15 case under section 305.

When informed that another interim distribution would soon be made from the Refco chapter 11 estate, the liquidator sought pre-chapter 15 recognition relief in the form of an injunction preventing the payments from going directly to Marex. On April 4, 2015, the bankruptcy court approved a stipulation among the parties which provided that, pending the court's decision on the debtors' chapter 15 petition, future Refco distributions would be deposited into the court registry. As of the date of the court's ruling, the registry contained approximately \$1.8 million.

The Bankruptcy Court's Ruling

The bankruptcy court denied the petition for recognition under chapter 15.

Initially, bankruptcy judge Robert E. Gerber remarked that the commencement of the BVI liquidation by Sevilleja to thwart enforcement of the \$5 million UK judgment against the debtors was "the most blatant effort to hinder, delay and defraud a creditor this Court has ever seen." With that preface, the judge stated as follows:

The case presents two issues as to which the underlying caselaw is thin. First, are chapter 15's statutory requirements for recognition of a foreign main proceeding satisfied when—by the [D]ebtors' design—the foreign representative's activities before his chapter 15 filing have been so minimal that the Court cannot find that the Debtors' [COMI] ... ever changed from the nation(s) where the Debtors actually did business to the different nation in which the foreign representative was appointed? ... And second, must a U.S. Bankruptcy Court tolerate debtor bad faith in a chapter 15 case that a U.S. court would never tolerate in a case under any other chapter of the Code?

Despite this paucity of guidance, Judge Gerber concluded that “the proper outcome with respect to the issues before this Court is not at all in doubt.”

Initially, Judge Gerber ruled that chapter 15 recognition should not be denied under the public policy exception stated in section 1506, which, as noted previously, permits a court to refuse recognition “if the action would be manifestly contrary to the public policy of the United States.” According to the judge, while U.S. courts, in examining the narrow scope of the exception, have scrutinized the goals of a party, the fairness of a foreign judicial system, or the fairness of that forum’s laws, “the Court has seen no precedent applying that exception to the misbehavior of a party alone.” Judge Gerber wrote, “It does not seem right to find a violation of U.S. public policy when U.S. debtors sometimes engage in the same or similar bad faith ... under U.S. law.”

Emphasizing that recognition is not a “rubber stamp exercise,” however, Judge Gerber determined that the BVI liquidation should not be recognized as a foreign main proceeding because the liquidator failed to prove that the debtors’ COMI was located in the BVI. The evidence demonstrated that the debtors never conducted any meaningful business in the BVI, which was merely a letterbox jurisdiction. Nor, Judge Gerber explained, did the debtors’ COMI migrate from other jurisdictions (i.e., Spain, Dubai, or the UK) to the BVI after the BVI liquidation began on the basis of the liquidator’s activities. “[T]he liquidator’s efforts were so minimal,” Judge Gerber wrote, “that the Court cannot find the necessary change in COMI.”

In addition, because the debtors never conducted any meaningful business in the BVI and the liquidator’s activities there were negligible, Judge Gerber found that the debtors never even had an establishment in the BVI. This precluded recognition of the BVI liquidation as a foreign nonmain proceeding.

In light of his conclusion that recognition should be denied, Judge Gerber declined to address whether dismissal of the chapter 15 case was warranted under section 305 or due to the bad faith of the debtors or their principal. He posited in dicta, however, that even if recognition of the BVI liquidation

had been warranted, a U.S. bankruptcy court is “not helpless in the face of a bad faith filing, including of the type this Court has found here.” For example, Judge Gerber explained, even if recognition had triggered the automatic stay, relief from the stay could be granted “for cause,” including a bad faith filing.

Finally, in light of his ruling denying recognition, Judge Gerber directed that, upon the effective date of his ruling, the stand-still stipulation with respect to future Refco distributions would expire. He further directed the parties to seek approval from the bankruptcy judge presiding over Refco’s chapter 11 case for disbursement of the funds held in the court registry.

Outlook

Enacted in 2005, chapter 15 is patterned on the 1997 UNCITRAL Model Law on Cross-Border Insolvency (the “Model Law”). Designed to provide effective mechanisms for dealing with cross-border insolvency cases, the Model Law has now been enacted by 42 nations or territories, 18 of which adopted some form of the law in 2015.

COMI migration and, in some cases, improper COMI manipulation have become more frequent issues with the increasing volume of cross-border bankruptcy and insolvency cases filed in Model Law jurisdictions. With 18 new Model Law jurisdictions in 2015 and more on the way, this trend can be expected to continue. *Creative Finance* suggests that, at least in the U.S., courts are both well aware of this development and determined not to rubber-stamp petitions for chapter 15 recognition. The ruling is noteworthy also because it reaffirms the notion that COMI can be legitimately migrated from one jurisdiction to another on the basis of the activities of a liquidator or other representative of the foreign debtor, but that did not occur in this case.

Still, *Creative Finance* is an unusual case. Judge Gerber was clearly offended by the brazenness with which the debtors’ principal attempted to manipulate the law as a means of thwarting a single creditor’s collection efforts. Other cases are less likely to present such a clear-cut case for denial of chapter 15 recognition.

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