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Offshore May No Longer Mean Out of Reach in Restructuring

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In recent years the private fund and investment adviser regulatory environment has been subject to highly publicized sweeping changes,[1] many of which had a meaningfully restrictive impact on activities conducted by both U.S. and offshore advisers and their funds.[2] It has also seen less notable and visible efforts to expand the U.S. regulatory and jurisdictional reach over U.S. and non-U.S. funds and their managers through, among others, strict enforcement efforts by the SEC[3] and other regulators and investor activism.[4] Many of the legislative and regulatory measures taken reflected an agenda that was attempting to ensure that the historical economic crisis of 2008 and various transgressions by industry participants were not repeated. Other measures taken were possibly more opportunistic and took hold when regulators or courts had an opportunity to consider a particular issue in more detail and, thus, may or may not reflect the original legislative intent to the same extent. Nonetheless, such measures became a part of the regulatory environment in which U.S. and offshore advisers operate and undoubtedly affect business decisions.

Through both legislative action and subsequent rulemaking, particularly in the wake of the adoption and implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act''), this regulatory expansion has been implemented in a variety of areas including, among others, the registration and on-going compliance requirements applicable to investment advisers on the federal and state levels and the regulation of products, in which advisers and

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[1] In recent years, numerous new and amended regulations were adopted. For example: (a) SEC Release No. IA-2256 (August 31, 2004) (instituting the requirement for the Investment Adviser Code of Ethics); (b) SEC Release No. IA-2968; (March 12, 2010) (expanding the investment adviser custody rule); (c) SEC Release No. IA-3221 (September 19, 2011) (enhancing the investment adviser registration requirements); (d) CFTC 17 CFR Parts 4, 145, and 147, 77 Fed. Reg. 11252 *et seq.* (February 24, 2012) (rescinding certain exemptions previously available to managers trading in futures instruments); (e) SEC Release No. 33-9287 (February 27, 2012) (increasing the net worth standard applicable to accredited investors); (f) SEC Release No. IA-3308 (March 31, 2012) (introducing reporting requirements for private funds); and (g) Final Volcker Rule, 79 Fed. Reg. 5536, 5550 (January 31, 2014) (restricting and/or prohibiting bank sponsorship of most private funds, among others).

[2] *See, e.g., Regulation of Offshore Advisers Expanded* by Kay A. Gordon and Joshua M. O'Melia, The Investment Lawyer, Vol. 19, No. 4, April 2012.

[3] *See, e.g.*, SEC Release No. 4065 (April 20, 2015) in which the SEC charged a chief compliance officer over his alleged failure to ensure that the firm disclosed conflicts of interests; *see also* SEC Release No. 4116 (June 15, 2015) in which the SEC charged chief compliance officer with failing to implement policies and procedures and conduct an annual review.

[4] *Some Big Public Pension Funds Are Behaving Like Activist Investors*, 11/29/2013, on page B1 of the NewYork edition of the New York Times.

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funds invest. As a result, offshore advisers and their funds in particular found themselves in danger of becoming subject to U.S. regulation while engaging in activities that previously appeared to be free from specific regulation on account of the location of their principals, investors or the products in which they invested or which they traded. In addition to all of these new concerns, offshore-investment advisers now should be aware of unintentionally subjecting themselves to U.S. jurisdiction in bankruptcy-related matters as well.

The domestic proceeding related to the liquidation of Fairfield Sentry Limited (''Sentry''), a British Virgin Island (''BVI'') fund, under Chapter 15 of the Bankruptcy Code[5] is arguably one of those situations that resulted in jurisdictional expansion without specific intent but more as a byproduct of focusing on specific matters as parties litigated various issues and raised arguments in defense of their ultimate economic goals. Sentry was severely impacted in late 2008 when Bernard Madoff's massive Ponzi scheme was exposed. Sentry was heavily invested in Bernard L. Madoff Investment Securities LLC (''BLMIS'') so its collapse and the commencement of the BLMIS SIPA[6] proceeding in the United States Bankruptcy Court for the Southern District of New York (''Bankruptcy Court'') had a ripple effect on other parties invested in BLMIS like Sentry.[7] Ultimately, Sentry ceased operations and started to wind-down following the exposure of the Ponzi scheme and, in 2009, commenced liquidation proceedings in the BVI.[8]

The first disputed issue arising from Sentry's Chapter 15 proceeding occurred in 2010, when Sentry petitioned the Bankruptcy Court to recognize the Sentry-BVI liquidation as a foreign main proceeding under Chapter 15 of the Bankruptcy Code and the Bankruptcy Court determined Sentry's center of main interests or COMI.[9] The Bankruptcy Court determined Sentry's COMI to be the BVI and granted the petition, which was appealed to the district court and then the United States Court of Appeals for the Second Circuit (''Second Circuit'') by a Sentry shareholder, Morning Mist Holdings Ltd. (''Morning Mist'').[10] Morning Mist's dispute focused on the recognition of Sentry's Chapter 15 matter as a foreign main-proceeding because that meant that Morning Mist's New York State Court derivative action concerning claims of breach of duties to Sentry by its directors, management and service providers was automatically stayed under Section 362 of the Bankruptcy Code.[11]

The Second Circuit affirmed the two lower court decisions and in reaching that result approved a widely adopted list of factors courts have generally considered when making the COMI determination, specifically: (a) the location of the debtor's headquarters; (b) the location of those who actually manage the debtor (which, conceivably could be the headquarters of a holding company); (c) the location of the debtor's primary assets; (d) the location of the majority of the debtor's creditors or of a majority of the creditors who would be affected by the case, and/or (e) the jurisdiction whose law would apply to most disputes.[12] While this list of factors was limited to the determination of whether a matter should be a main or non-main proceeding under Chapter 15 of the Bankruptcy Code, the analysis that resulted from the decisions granting Sentry's Chapter 15 petition as a foreign main proceeding was important because it could potentially come into play respecting other areas where a court evaluates and determines its reach over and to foreign funds and their assets.

A more affirmative extension of U.S. jurisdictional reach over the actions and assets of a foreign fund emerged in the September 2014 decision issued by the Second Circuit in *Fairfield Sentry Ltd. v. Farnum Place, LLC (In re Fairfield Sentry Ltd.)* that addressed matters concerning the sale of Sentry's claim from the BLMIS SIPA proceeding.[13] In the SIPA Claim Decision the Second Circuit vacated and remanded decisions of the District Court and the Bankruptcy Court that concerned whether the review of the Sentry claim sale required review under Section 363 of the Bankruptcy Code.[14] The practical impact of the SIPA Claim Decision meant that the liquidator for an offshore BLMIS feeder fund could now undo the sale of its $230 million claim in the BLMIS SIPA Proceeding (the ''SIPA Claim'') to another hedge fund as part of a review of the sale agreement in Sentry's Chapter 15 proceeding.[15] This outcome was based on the Second Circuit's conclusion that the sale of a SIPA claim is a '' 'transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States,' 11 U.S.C. section 1520(a)(2), and therefore the sale is subject to review under section 363 . . . .''[16]

The specific issue in dispute was whether the sale of the SIPA Claim required review by the Bankruptcy Court under the standards of Section 363 of the Bankruptcy Code.[17] As part of the sale of the SIPA Claim it was agreed that Sentry would obtain approval of the SIPA Claim sale from both the Bankruptcy Court and the BVI court.[18] After the sale closed, the trustee in the BLMIS SIPA proceeding entered into a settlement that changed the economics surrounding the potential recoveries on the SIPA Claim.[19] As a result, Sentry's liquidator did not seek court approval, but the SIPA Claim purchaser went to the BVI court to have the sale approved, which the BVI court ultimately approved.[20] After the BVI court's approval, Sentry's liquidator sought

[5] 11 U.S.C. § § 101 – 1532.

[6] Congress enacted SIPA to prevent the failure of brokerage houses, restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers. *See*, *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412, 415 (1975). SIPA is designed, in part, to apportion responsibility for carrying out the various goals of the legislation to several groups. Among them are the SEC, various securities industry self-regulatory organizations, and SIPC. SIPA was designed to create a new form of liquidation proceeding. SIPA is codified in Title 15 of the United States Code at Sections 78aaa – 111.

[7] *Morning Mist Holdings Ltd., et al. v. Kenneth Krys, et al. (In re Fairfield Sentry Ltd.)*, 714 F.3d 127, 130 (2d Cir. 2013).

[8] *Id.* at 131.

[9] *Id.*

[10] *Id.* at 131-32.

[11] *Id.* at 131.

[12] *Id.* at 137 citing *In re SPhinX, Ltd.*, 351 B.R. 103, 117 (Bankr. S.D.N.Y 2006).

[13] *Kenneth Krys v. Farnum Place, LLC (In re Fairfield Sentry Ltd.)*, 2014 BL 267213, 768 F.3d 239 (2d Cir. 2014) (the ''SIPA Claim Decision'').

[14] *Id.* at 241, 246, & 247.

[15] *Id.* at 242-43.

[16] *Id.* at 241.

[17] *Id.* at 243.

[18] *Id.* at 242.

[19] *Id.*

[20] *Id.* at 242-43.

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review by the Bankruptcy Court under Section 363 of the Bankruptcy Code with the end of goal of having the sale revoked on the grounds that it was not a good economic deal for Sentry's estate.[21] In denying Sentry's application, the Bankruptcy Court held a Section 363 review was not necessary because there was not ''property'' within the United States being transferred.[22] In essence, the parties disputed if the ''property'' to be focused on was the SIPA Claim or the BLMIS fund and, if the SIPA Claim, the location of the SIPA Claim.[23] While the Second Circuit determined that the '' 'property' is the SIPA Claim itself, not the BLMIS Fund,'' it disagreed with the purchaser's argument that the SIPA Claim was not within the territorial jurisdiction of the United States.[24] Specifically, the Second Circuit stated that ''[w]ithin the territorial jurisdiction of the United States'' is defined in Section 1502(8) as: ''[T]angible property located within the territory of the United States and intangible property deemed under applicable nonbankruptcy law to be located within that territory, including any property subject to attachment or garnishment that may properly be seized or garnished by an action in a Federal or State court in the United States.''[25]

The Second Circuit concluded that the Bankruptcy Court's analysis was incomplete[26] in light of the fact that, as previously addressed, Section 1502(8) of the Bankruptcy Code deems ''any property subject to attachment or garnishment that may be properly seized or garnished by an action in a United States court to be within the territory of the United States.''[27] When analyzing attachment ''with respect to intangible property that has as its subject a legal obligation to perform, the situs is the location of the party of whom that performance is required pursuant to that obligation.''[28] Further, it had been ''recognized that a contractual agreement could constitute contingent property interests attachable and assignable, and thus subject to CPLR 5201(b).''[29] While Sentry and the trustee in the BLMIS SIPA proceeding ''[did] not have a contractual relationship, the [t]rustee [was] statutorily obligated to distribute to Sentry its pro rata share of the recovered assets. Therefore the situs of the SIPA Claim is the location of the [t]rustee, which is New York.''[30]

The Second Circuit also addressed the lower courts' comity discussions and stated that it was not apparent that the foreign court (here the BVI court) expected or desired deference.[31] The Second Circuit began its comity analysis by acknowledging that Congress specifically directed courts, ''[i]n interpreting [Chapter 15], . . . [to] consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions.''[32] However, the Second Circuit concluded that ''Chapter 15 does impose certain requirements and considerations that act as a brake or limitation on comity.''[33] The Second Circuit concluded that the Bankruptcy Court improperly gave deference to the BVI court and it should have conducted a Section 363 review of the transfer of the SIPA Claim.[34]

The SIPA Claim Decision makes clear that Section 363 of the Bankruptcy Code applicability to a Chapter 15 ancillary proceeding is mandated under the clear terms of the Bankruptcy Code, specifically, Section 1520(a)(2).[35] And this applicability obviously means that a court is required to evaluate the proposed asset transfer under the standards established in connection with Section 363 reviews.[36]

SIPA considerations are clearly relevant for U.S. registered broker/dealers and their clients and an offshore fund, its manager, and fund investors would generally expect to benefit from SIPA protections should such fund decide to engage a U.S. registered broker/dealer (as such parties may also benefit from being subject to U.S. jurisdiction generally). This determination to engage a U.S. registered broker dealer, however, should be evaluated now in light of the SIPA Claim Decision because there is yet another hook that brings an offshore person within the reach of potential U.S. jurisdiction. This is true even if the fund and/or its offshore manager otherwise fail to become subject to such jurisdiction within the meaning of more traditional ''conducts and effects'' securities analysis[37] or on the basis of statutory exemptions available under the Dodd-Frank Act.[38] While utilizing a U.S. registered broker/dealer can be tantamount to some U.S. presence, it is not always indicative of such presence within the meaning of the existing securities precedent (such as the ''conducts and effects'' test) and has not necessarily been viewed previously as an automatic hook for U.S. jurisdictional reach over foreign funds and their assets at least as far as a liquidation/bankruptcy analysis was concerned. Therefore, the SIPA Claim Decision poten-

[21] *Id.* at 243.
[22] *Id.*
[23] *Id.* at 244.
[24] *Id.*
[25] *Id.* (internal quotations omitted).
[26] *Id.*
[27] *Id.*; *see also* 11 U.S.C. § 1502(8).
[28] *Id.* at 245.
[29] *Id.* (internal citations omitted).
[30] *Id.*
[31] *Id.* at 246.
[32] *Id.* at 245; citing 11 U.S.C. § 1508.
[33] *Id.* citing *In re Vitro S.A.B. de C.V.*, 701 F.3d 1031, 1054 (5th Cir. 2012) (stating that comity is ''an important factor in determining whether relief will be granted'' under Chapter 15, but is not a *per se* rule).
[34] *Id.* at 246.
[35] *Id.*
[36] *Id.* Moreover, in closing the SIPA Claim Decision, the Second Circuit, in dicta, provided guidance respecting the review that should be conducted under Section 363 of the Bankruptcy Code. *Id.* Specifically, the Second Circuit pointed out, based on prior case law, that in reviewing a Section 363 application courts are: (1) required to expressly find evidence of a good business reason to grant an application; (2) to review all salient factors pertaining to the preceding, which includes whether an asset is increasing or decreasing in value; and (3) to secure the best possible bid for the benefit of a debtor's creditors. *Id.* 246-47. Based on this guidance, the Second Circuit noted that in deciding whether to approve a Section 363 application here, consideration should be paid to the subsequent increase in value of the SIPA Claim from that of the time of the original sale agreement. *Id.* at 247.
[37] *Protecting Investors: A Half-Century of Investment Company Regulation*, a report of the Division of Investment Management, United States Securities and Exchange Commission, May 1992, pp. 227-236.
[38] *See* Rule 203(m)-1 and Rule 202(a)(30)-1 under the Investment Advisers Act of 1940, as amended (the ''Advisers Act'') codifying the private fund adviser exemption and the foreign private adviser exemption from registration under the Advisers Act. *See also* SEC Release No. IA-3222 (July 21, 2011).

tially constitutes a new expansion of such reach. A liquidation/bankruptcy analysis (while not always the analysis deemed to be relevant to an operating business) is of course important in any decision making process given that it ultimately determines how and if the assets of a fund and/or a client are protected regardless of whether such process involves an offshore investor investing in a fund, an offshore fund considering a change in service providers, or legal counsel offering structuring solutions to a foreign adviser.

In the end, some industry participants, focusing on the potential increase of the assets available to creditors and investors, are excited about the SIPA Claim Decision and the fact that the decision provides certainty to offshore liquidators as to the steps they need to take when dealing with U.S. assets. On the other hand, the SIPA Claim Decision also introduces further uncertainty into the regulatory environment of non-U.S. persons choosing to engage with U.S. counterparties. Will this result in some additional hesitation on the part of non-U.S. market participants when determining to utilize U.S. brokers or otherwise engage with U.S. service providers? Only time will tell.

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