

NEW YORK

RESTRUCTURING AND INSOLVENCY CLIENT ALERT

APRIL 2013

## SECOND CIRCUIT RULES ON DETERMINATION OF COMI IN CHAPTER 15 PROCEEDINGS

### INTRODUCTION

Last week, the Second Circuit Court of Appeals, affirming the United States District Court and the United States Bankruptcy Court for the Southern District of New York, held that the center of main interests (“COMI”) for Fairfield Sentry (“Fairfield”) was the British Virgin Islands (“BVI”), upholding recognition of Fairfield’s foreign insolvency proceeding under Chapter 15 of the Bankruptcy Code. *Morning Mist Holdings, Ltd. v. Kryz (In re Fairfield Sentry Ltd.)*, 2013 WL 1593348 (2d Cir. April 16, 2013). The *Fairfield Sentry* decision is the first major decision by the Second Circuit Court of Appeals addressing Chapter 15 of the Bankruptcy Code, and, more specifically, COMI.

Prior to the decision in *Fairfield Sentry*, there existed a split within the Second Circuit as to whether COMI was determined as of the commencement of the debtor’s foreign proceeding or the filing of the Chapter 15 petition for recognition. *Fairfield Sentry* resolves that split, holding that COMI should be determined as of the time of the Chapter 15 filing.

### BACKGROUND

Organized in 1990 under the laws of the BVI, Fairfield was the largest of the “feeder funds” that invested with Bernard L. Madoff Investment Securities LLC, which was later revealed to be a Ponzi scheme and the largest financial fraud in United States history. After Madoff’s arrest in December 2008, Fairfield commenced a wind-down of its operations. In May 2009, Morning Mist, a Fairfield shareholder, commenced a derivative action against Fairfield in New York state court. In July 2009, Fairfield entered into liquidation proceedings in the BVI, and, in June 2010, the BVI liquidator petitioned the Bankruptcy Court for recognition of the BVI liquidation proceeding.

The dispute before the Second Circuit arose out of a derivative lawsuit filed against Fairfield by Morning Mist Holdings Limited (“Morning Mist”), which was blocked by the stay imposed by the Bankruptcy Court’s recognition of Fairfield’s BVI insolvency proceedings. In an attempt to proceed with the suit, Morning Mist appealed the Bankruptcy Court’s Chapter 15 recognition order.

### THE TIME PERIOD FOR DETERMINING COMI

To determine Fairfield’s COMI for purposes of Chapter 15, the Bankruptcy Court examined the period between December 2008, when Fairfield stopped doing business, and June 2010, when the Chapter 15 petition was filed. The Bankruptcy Court also considered Fairfield’s liquidation activities in its COMI analysis. Pursuant to Section 1520 of the Bankruptcy Code, the Bankruptcy Court’s recognition of the BVI liquidation as a foreign main proceeding imposed an automatic stay on actions against Fairfield in the United States, including Morning Mist’s derivative suit.

The Bankruptcy Court also held that, in the alternative, even if the BVI liquidation qualified only as a “nonmain” proceeding (in which a stay would not be automatic), a stay of Morning Mist’s suit would be appropriate under Section 1521 of the Bankruptcy Code, which allows a court to grant additional relief to a debtor in a foreign proceeding. The District Court affirmed the Bankruptcy Court’s decision. The Second Circuit reviewed the Bankruptcy Court’s factual findings under a “clearly erroneous” standard and its legal conclusions *de novo*.

Section 1517 of the Bankruptcy Code provides that a “foreign proceeding shall be recognized . . . as a foreign main proceeding if it is pending in the country where the debtor has the center of its main interests.” The statute does not define COMI. However, Section 1516 of the

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Bankruptcy Code does establish a rebuttable presumption that “the debtor’s registered office . . . is presumed to be the center of the debtor’s main interests.”

Morning Mist argued that the Bankruptcy Court should have examined Fairfield’s entire operational history when determining COMI, instead of analyzing COMI as of the date of the Chapter 15 petition. The Second Circuit disagreed, affirming the Bankruptcy Court’s holding that the relevant date for determining COMI is the date of the petition for recognition under Chapter 15. Previously, courts within the Second Circuit had analyzed COMI as of the date of the commencement of the foreign insolvency proceeding.

The Second Circuit reasoned that the use of the present tense in the text of Section 1517, providing that a “foreign proceeding shall be recognized . . . as a foreign main proceeding if it is pending in the country where the debtor has the center of its main interests,” favored the analysis applied by the Bankruptcy Court. The Second Circuit also considered precedent from other circuits, including a decision by the Fifth Circuit Court of Appeals that squarely rejected use of the debtor’s operational history as a means to determine COMI.

Morning Mist had argued that COMI should be determined utilizing the jurisdictional concept of “principal place of business,” which would necessarily require consideration of a debtor’s operational history. In dismissing this argument, the Second Circuit looked to the former Section 304 of the Bankruptcy Code, the predecessor to Chapter 15, which utilized the “principal place of business” concept. The Second Circuit pointed out that Chapter 15’s drafters abandoned the concept and, thus, the court was unconvinced that it should be employed in the instant case.

Further, the Second Circuit looked to the Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency (the “UNCITRAL Guide”), which indicates that the concept of COMI was drawn from the European Union Convention on Insolvency

Proceedings, suggesting that COMI is the place where the debtor “conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.” While the Second Circuit noted that the language “on a regular basis” would seem to point towards evaluation of a longer time period in the debtor’s operational history, the court held that such a concept is not a fit for construing Chapter 15, because the EU Regulation contains a mechanism for automatic recognition of insolvency proceedings filed in other member states, unlike Chapter 15.

The court then examined EU case law, noting that it focuses on the regularity and ascertainability of a debtor’s COMI, and also reflects a concern about possible manipulation of COMI by debtors. Thus, the Second Circuit held that a debtor’s COMI should be determined by its activities at the time of filing the Chapter 15 petition, but that a court may “consider the period between the commencement of the foreign insolvency proceeding and the filing of the Chapter 15 petition to ensure that a debtor has not manipulated its COMI in bad faith.” Even though the bankruptcy court had examined a longer time period, starting with Madoff’s arrest, the Second Circuit found that difference immaterial and affirmed the bankruptcy court’s holding.

**COMI FACTORS**

Morning Mist also argued that Fairfield’s liquidation activities were irrelevant to the determination of its COMI, contrary to the holding of the bankruptcy and district courts. The Second Circuit examined the relevant precedent, noting that courts have employed a variety of factors to determine COMI. Turning again to the EU regulation, the court noted the importance of regularity and ascertainability by third parties, but also noted that the absence of a statutory definition indicates that the meaning is open-ended. Therefore, the Second Circuit affirmed the lower courts’ consideration of liquidation activities in its COMI analysis.

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## THE PUBLIC POLICY EXCEPTION

Finally, the Second Circuit addressed Morning Mist's argument that the recognition of the BVI proceeding violated the public policy of the United States because the court records in the BVI liquidation are sealed. In the BVI, as a matter of course, only certain court records are made available to non-parties.

The public policy exception contained in Section 1506 of the Bankruptcy Code provides: "Nothing 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." Looking to the plain language of the statute, the UNCITRAL Guide, which states that the exception contained in Section 1506 of the Bankruptcy Code should be read "restrictively" and invoked only "under exceptional circumstances concerning matters of fundamental importance . . .," and relevant federal case law, which has applied the exception sparingly, the Second Circuit affirmed the lower courts' decision to grant recognition.

In support of its holding, the Second Circuit noted that public summaries of the BVI proceedings were available and any non-party may apply to the court for access to sealed documents, and cited precedent holding that access to court records is not absolute, holding that such access is not an "exceptional and fundamental value." Therefore, the court held that Morning Mist had not cleared the high bar required to invoke the exception under Section 1506 of the Bankruptcy Code.

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## FOR FURTHER INFORMATION, CONTACT:

### L.P. HARRISON 3RD, PARTNER

E-MAIL: [LHARRISON@CURTIS.COM](mailto:LHARRISON@CURTIS.COM)

TEL.: 212 696 6199

### STEVEN J. REISMAN, PARTNER

E-MAIL: [SREISMAN@CURTIS.COM](mailto:SREISMAN@CURTIS.COM)

TEL.: 212 696 6065

### JERROLD L. BREGMAN, PARTNER

E-MAIL: [JBREGMAN@CURTIS.COM](mailto:JBREGMAN@CURTIS.COM)

TEL.: 212 696 6185

### MICHAEL A. COHEN, PARTNER

E-MAIL: [MACOHEN@CURTIS.COM](mailto:MACOHEN@CURTIS.COM)

TEL.: 212 696 6900