

Hedge Fund Workouts and Chapter 11 Cases

Charles A. Dale III, Eric A. Henzy, Francis C. Morrissey

Table of Materials

1. *What is a Hedge Fund?*-Background and Diagrams of Common Hedge Fund Structures
2. *How Does Chapter 15 Apply?*-Explanation of Scope and Venue of Chapter 15 Proceedings for Offshore Hedge Funds
3. *When is Equity Considered Debt?*-Issues Involving Payment and Valuation of Investor Redemption Claims [handout]
4. *Who Has Fraudulent Transfer Exposure?*-Clawback of Prepetition Redemption Payments and Good Faith Transferee Defense [handout]

What is a Hedge Fund?¹

I. Hedge Funds Generally²

Although commentators, regulators, and industry participants regularly use the term “hedge fund,” there is, in fact, no universally accepted or precise legal definition of the term. Alfred Winslow Jones is credited with creating one of the first hedge funds, organized as a private partnership, in 1949. The fund invested in equities and used leverage and short-selling to “hedge” the risk of its corporate securities holdings and thereby, as the lore goes, the term “hedge fund” was born.

Hedge funds can be recognized by a handful of characteristics that distinguish them from other investment vehicles. First, hedge funds generally do not register either themselves or their securities under the provisions of the Investment Company Act of 1940 (the “1940 Act”) or the Securities and Exchange Act of 1934 (the “Exchange Act”). To avoid the registration requirement under the 1940 Act as investment companies, hedge funds generally rely on one of two exemptions therein, under the rigors of which they are required to sell their securities only to certain sophisticated investors.³ To avoid having to register their securities under the Exchange Act, hedge funds generally conduct only so-called “private offerings” of their securities, in which information about an offering becomes known to potential investors through direct, preexisting relationships and word of mouth, rather than by public advertising. By avoiding the registration requirements of the various securities laws, hedge funds can, among other things, invest in securities and use investment techniques that would otherwise be prohibited.

Second, the structure and management of a hedge fund is fairly unique in the investment company universe. Hedge funds are generally organized as either limited partnerships or limited liability companies⁴ (whereas mutual funds are typically organized as corporations or trusts), and the managing partner or managing member generally acts as the investment manager for the fund. The managing member or managing partner, which can be either an individual (or group thereof) or an entity, generally invests a significant sum of its own capital into the fund. This capital contribution helps to assure investors that the interests of management are closely aligned with those of shareholders.

¹ Authored by Charles A. Dale III, Mackenzie L. Shea, Matthew P. O’Connor, and Kevin T. Teng of K&L Gates, LLP.

² For a more detailed discussion of hedge funds, see *Implications of the Growth of Hedge Funds*, Staff Report to the Securities and Exchange Commission (Sept. 2003), and *Global Hedge Funds: Navigate the Maze of Opportunities*, as published by PFPC, Inc.

³ These exemptions are set out in sections 3(c)(1) and 3(c)(7) of the 1940 Act.

⁴ Offshore hedge funds formed in the Cayman Islands, Bermuda, or the Virgin Islands tend, however, to be organized as limited duration corporations.

Third, hedge funds generally have fee structures unlike those of typical investment companies. In a typical hedge fund, the investment manager (*i.e.*, the managing partner or managing member) will be compensated with two separate fees, a management fee and an incentive fee. The management fee is generally a percentage (somewhere between 1-2%) of the total assets under management in the fund. The manager receives this fee regardless of the performance of the fund. In addition, the manager is ordinarily entitled to receive an incentive fee, normally expressed as a percentage (generally near 20%) of the gains the fund will have accumulated in a given year. Many times the incentive fee will be subject to a “high-water mark,” which negates the fund’s duty to pay the manager an incentive fee until the fund reaches at least a certain specified level of asset value. Incentive fees in periods of positive performance can and do generate huge sources of income for the manager.

Although not necessarily unique, the open-end nature of a hedge fund is another important characteristic with which to be familiar. Generally, there is no secondary market for hedge fund interests. Accordingly, much like open-end mutual funds, hedge fund investors can generally opt to have the fund return their investment, including any gains or losses, to them – in industry parlance, to “redeem” their shares in the fund. Redemption requests, the mechanism by which an investor redeems his shares, typically require some period of notice (commonly 90 days) and are paid out at the end of a certain period, usually the end of a quarter.

Typical Investments and Strategies.

In addition to trading in equities, hedge funds commonly trade fixed-income securities, currencies, exchange-traded futures, over-the-counter income securities, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, commodity options, and a host of other non-security investments (*e.g.*, real estate).

Hedge funds may engage in any of the following strategies (among others) or any combination thereof: fixed-income arbitrage, convertible bond arbitrage, mortgage-backed securities arbitrage, and derivatives arbitrage; event-driven strategies (*e.g.*, bankruptcy, merger, etc.); long/short strategies; or tactical strategies (*e.g.*, global macro, managed futures).

The Duties of a Hedge Fund Manager.

The Investment Advisers Act of 1940 (the “Advisers Act”) requires that any person who engages in the business of advising others as to the value of or advisability of investing in securities (an “investment adviser”) register with the Securities and Exchange Commission (“SEC”). The Advisers Act provides an exception for investment advisers with fewer than 15 clients, and, as the law currently stands, a hedge fund is generally deemed to be one client.⁵ Thus, hedge fund managers are generally not required to register under the Advisers Act. However, because hedge fund managers, although generally unregistered, do fall within the Advisers Act’s definition of

⁵ In 2004, the SEC adopted a rule that would have had the effect of forcing investment advisers to look through hedge funds to their underlying investors for purposes of qualifying for the exception. However, in 2006, the United States Court of Appeals for the D.C. Circuit vacated the rule, and its original interpretation now stands.

investment adviser, they owe their respective funds and investors a fiduciary duty that requires the manager place the interests of the hedge fund and its investors first, or at least fully disclose any material conflict of interest the manager may have with the fund and/or its investors.⁶

A significant issue facing hedge fund managers as a result of their status as fiduciaries arises in the context of asset valuation. Because of the wide variety of often-exotic assets that hedge funds hold, valuation is frequently a complex and ambiguous process. The complexity derives from, among other factors, the fact that market quotations (which make for relatively simple valuation of a mutual fund's more plain-vanilla assets) for many of a fund's assets simply do not exist, either because there is a thinly traded market for those assets or no market for them at all. The fee structure in place at most hedge funds presents the investment manager with an inherent incentive to overvalue the funds assets, which would accordingly increase the size of its incentive fee. If the assets are overvalued, redeeming investors reap the benefit of the overvaluation (because their shares are being redeemed for more than they are actually worth) at the cost of remaining investors (because the pool of assets in which they hold an equity stake has been reduced by the overpayment to the redeeming investors). Similarly, the interests of withdrawing shareholders are impaired when the assets of a fund are undervalued.⁷ Thus, in either situation – overvaluation or undervaluation – the hedge fund manager will ultimately wind up breaching the fiduciary duty it owes to some of the funds investors.

Master-Feeder Structure.

During the early 1990s, establishing hedge funds in a master-feeder structure became popular practice. In typical practice, three entities comprise this master-feeder structure: a domestic feeder fund, an offshore feeder fund, and a domestic master fund. The domestic funds are typically structured as limited partnerships, and the offshore fund as a corporation organized under the laws of Bermuda, the Cayman Islands, or the Virgin Islands. Individuals and entities invest in the unmanaged feeder funds, which, as limited partners in the master fund, invest all (or substantially all) of their assets in the master fund. The master fund's assets are managed according to the applicable strategy.

The offshore feeder fund in the master-feeder is a tax-favorable investment vehicle for non-U.S. investors and tax-exempt U.S. investors. Non-U.S. investors use the offshore feeder as a mechanism to avoid U.S. taxes on gains; tax-exempt U.S. investors use the offshore feeder as a mechanism for avoiding unrelated business taxable income that could otherwise become taxable

⁶ § 206 of the Advisers Act reads: “It shall be unlawful for *any investment adviser*, . . . acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.” (Emphasis added).

⁷ When a fund's shares are undervalued, remaining investors benefit at the cost of withdrawing investors: the redeeming investors receive less than the actual value of their stake in the fund, and the remaining investors therefore have a pool of assets is more valuable than it otherwise would have been had the shares not been undervalued.

under U.S. law. For instance, a tax-exempt investor who has purchased a domestic partnership utilizing leverage may be subject under U.S. law to taxes on gains from any debt-financed income it derives therefrom. Investing through the offshore feeder funds moots concern about the potential imposition of this tax.

II. Redemptions and Valuation

Although hedge funds typically seek to qualify for an exception under 3(c)(1) or 3(c)(7) of the 1940 Act, and thus are unlikely to file a registration statement with the SEC, it would be erroneous to conclude that hedge funds are “unregulated” or even “lightly regulated”. Hedge fund managers are bound by the antifraud provisions within the Advisers Act. As discussed above, these provisions have been interpreted to impose fiduciary obligations on investment advisers with respect to their clients. Furthermore, Rule 10b-5 of the Exchange Act (which applies to sales of securities by the fund) and Rule 206(4)-8 under the Advisers Act (which applies to the adviser) both provide that untrue statements of material fact or omissions of such material facts, as well as any other fraudulent acts or practices would violate federal securities laws.

Fund Documents

The valuation of a fund’s assets and the fund’s ability to manage liquidity are to a large extent governed by the fund’s organizational and offering documents. For a domestic hedge fund, these documents typically include a private placement memorandum, a limited partnership agreement or limited liability company agreement and a subscription agreement.⁸ The limited partnership agreement, as the name implies, is an agreement among the investors (as limited partners) and the fund manager (as the general partner), and sets forth the rights and obligations of both parties as well as more general provisions concerning the operation of the fund. The subscription agreement usually contains several representations and warranties by the investor, the inclusion of which is to ensure that the subscriber is a suitable and eligible investor, and that the fund will not violate federal securities laws by selling unregistered shares to the subscriber in a private placement.

The private placement memorandum (also called an “offering memorandum”) serves two very important purposes, which do not always sit well together. On the one hand, the private placement memorandum is a critical marketing document (in light of the fact that hedge funds typically may not advertise in the same manner as mutual funds), and as such must present the fund as an attractive investment vehicle to potential investors. On the other hand, the private placement memorandum also serves as evidence that the fund’s disclosure obligations have been met, and must contain sufficient consideration of investment risks such that disgruntled investors cannot later claim that they were misled or that key information was omitted. While an extensive discussion of the fund’s risks might seem out of place in a marketing document, an accurate and complete picture of the fund and its investments may serve to insulate the fund manager from any subsequent investor claims.

⁸ An offshore fund, if organized as a corporation, will not have a limited partnership agreement, but will instead have a private placement memorandum and articles of association.

Although the private placement memorandum and the limited partnership agreement serve very different purposes, there is some degree of overlap in the subject matter addressed in those documents (the difference being that the private placement memorandum is essentially descriptive whereas the limited partnership agreement is prescriptive). In particular, the two processes described below (redemptions and determination of net asset value) will receive ample attention in both the limited partnership agreement and the private placement memorandum. Any discrepancies in the way these processes are described in the private placement memorandum and in the limited partnership agreement should serve as a warning sign to potential investors. If an investor wishes to contest a fund's valuation of its shares or its underlying assets, or if the investor contends that a redemption request was improperly processed, the basis for that claim will generally lie in some departure from the fund's practices as set forth in these two key documents.

Redemptions and Liquidity Management Mechanisms

Liquidity is an area in which the hedge fund investor and the hedge fund manager may appear, at least on the surface, to have some degree of competing interests. Most investors, one would assume, would prefer to have the option of taking some or all of their invested capital out of an investment vehicle whenever they please. Some investment vehicles do in fact provide investors with this freedom. Mutual funds, for example, offer almost daily liquidity, which allows investors to invest or divest according to their liquidity needs. Hedge fund managers, in contrast, would generally prefer that any invested capital remain under their management with minimal interference or interruption. Although a cynical observer might point out that this is because hedge fund manager compensation is usually tied to the amount of assets under management, a more charitable view would see that frequent redemptions impose significant additional accounting expense on the fund and could potentially handicap the hedge fund manager's ability to engage in their chosen investment strategies.

Investing in certain illiquid asset classes may require a manager to commit a certain portion of investor capital for substantial periods of time before that investment can realize any gains. Hedge fund managers could thus reasonably contend that limiting investor liquidity is in the best interests of the fund and the investors, since it would allow the manager the freedom to implement precisely those strategies that enable some hedge funds to outperform more traditional investment vehicles, such as mutual funds.

Lock-Ups

There are a number of mechanisms available to hedge funds for controlling liquidity, and hedge fund managers typically adopt some or all of these mechanisms, depending on what they believe their targeted investors will consider acceptable. New or initial investments in a hedge fund are often subject to a "lock-up" period. During such lock-up periods, which generally range from one to two years, investors may not be able to withdraw their capital without incurring a penalty. Such an arrangement is sometimes referred to as a "soft" lock-up, to distinguish it from a "hard" lock-up, where the investor has no right to redeem at all prior to the expiration of the lock-up

period. Fund managers will, however, typically retain the power to waive lock-up provisions in order to attract certain investors and to accommodate hardship cases.

Hedge funds typically allow investors to withdraw capital on a monthly, quarterly or bi-annual basis once the lock-up period has elapsed. Hedge fund managers will also structure such liquidity provisions such that investors must provide adequate notice if they intend to withdraw capital on a given withdrawal date. This is because certain less liquid holdings may not be easily or quickly unwound, and advance knowledge of redemption requests is critical if the fund managers are to effectively plan for the liquidation of holdings in order to meet redemptions. Consequently, the fund documents are likely to contain detailed descriptions of any notice requirements attached to redemption requests.

Gates

Beyond limiting withdrawals to pre-determined intervals, hedge fund managers can also control liquidity by imposing “gates” on the redemption request process.⁹ A gate limits the amount of capital withdrawn on a given withdrawal date to a certain percentage of the fund’s assets. If the combined redemption requests exceed the specified percentage of fund assets, the manager reduces the amount withdrawn by each investor accordingly (usually *pro rata* based on the withdrawal amount requested). In certain cases, the existence of a gate may create an incentive for investors to place redemption requests, only to revoke these requests immediately prior to the given withdrawal date. Such patterns may develop, for example, where investors are worried about shouldering a disproportionate share of the negative impact to their portfolio when a fund performs poorly. Although the fund manager may appreciate having few redemption requests to meet, in practice the revocation of redemption requests creates difficulties for managers, who may have made arrangements to liquidate assets in order to satisfy redemption requests. In order to eliminate or minimize the impact of this practice, some hedge fund managers have imposed the additional requirement that redemption requests be irrevocable. Because of the administrative costs associated with the processing of redemption requests, it is also normal for hedge funds to set minimum amounts for such requests.

Holdbacks

Most fund documents will also provide that a majority of the investor’s money will be returned within a short time after the effective date of the redemption, with the remaining balance to be paid shortly after the issuance of the fund’s financial statement. This can sometimes spell a substantial waiting period for the investor, depending on how early in the fund’s financial year the redemption request is submitted. The rationale for paying proceeds in two installments lies in the fact that the fund’s adviser and the fund’s accountant may arrive at slightly different determinations of the fund’s net asset value as of the effective date of the redemption.

Side Pockets

⁹ SCOTT J. LEDERMAN, HEDGE FUND REGULATION, §2:3:3, (2009)

Another arrangement available to hedge funds is the creation of “side-pockets.” These arrangements are sometimes used when funds invest in assets or securities that are extremely illiquid, such as shares of distressed companies, restricted securities or real estate. When a fund acquires an asset that it decides will be subject to side-pocket provisions, only those investors currently invested in the fund will participate in the side-pocket investment. The fund then creates a dedicated account and a special class of shares tied to the fair market value of the side pocket investment. Participating investors are generally not permitted to make redemptions of shares related to side-pocket investments until the manager decides to liquidate the asset. Segregating illiquid or hard-to-value assets from the liquidity profiles of investors who invest in the fund subsequent to the acquisition of such assets allow fund managers to accomplish a number of goals: firstly, segregating assets allows the fund to avoid inadvertently overstating or understating the value of these special investments, and thus running afoul of regulators.¹⁰ Secondly, insulating these assets from redemption requests allows hedge fund managers to address redemption requests in a more equitable fashion, because the fund avoids having to prematurely liquidate an asset to meet requests, which often disadvantages those investors who have elected not to withdraw capital.¹¹

In-Kind Payments

A further wrinkle in the redemption process from the investor’s perspective is the possibility of in-kind or in-specie payments. Most fund documents include provisions preserving the fund manager’s ability to make redemption payments with securities held by the fund. The ability to make in-kind payments becomes critical when the fund is unable to meet redemption requests without unwinding illiquid assets in a manner that would be detrimental to the remaining investors in the fund.

In addition to the various mechanisms described above, many hedge funds structure their organizational documents to allow the fund broad discretion to manage liquidity, including the power to suspend the valuation of shares, or to suspend redemptions altogether, if the fund makes the determination that it is in the best interests of the fund to do so. Such provisions serve to prevent the possibility of a “run” on the fund’s assets

Valuation

When an investor chooses to redeem some or all of its interest in a hedge fund, the money received from the hedge fund (assuming that payments are not being made in-kind and that no capital is being held back) is usually a function of the fund’s “net asset value.” Net asset value is usually calculated by adding the value of the fund’s investments, cash and other assets, and subtracting its accrued liabilities and expenses. Valuation is typically determined in accordance with generally accepted accounting principles (“GAAP”) as applied in the United States. An investor who submits a redemption request receives an amount proportional to the net asset value of the fund, as of a specific valuation date. The exact manner in which an investor’s share is

¹⁰ *Id.*

¹¹ *Id.*

calculated depends on the specific characteristics of the fund in question, and will likely be very different, depending on whether the fund is an offshore fund or a domestic fund.

Domestic hedge funds are often organized as limited partnerships, in order to afford investors the advantage of pass-through tax treatment. When an investor chooses to make an initial investment in a hedge fund organized as a limited partnership, the fund documents typically provide for the creation of a capital account for that investor.¹² Upon certain accounting dates specified in the fund's documents, the investor's capital account is either credited or debited by an amount proportional to the appreciation or depreciation of the fund's net asset value. Depending on the specific characteristics of the fund in question, the investor's capital account is often subject to a further "reallocation" to the general partner's capital account. This reallocation (sometimes referred to as an "incentive allocation" or a "performance allocation") represents the performance fee paid to the fund manager. When the investor makes a redemption request, the amount redeemed is simply subtracted from the amount in the investor's capital account.

Unlike domestic hedge funds, offshore funds are frequently organized as corporations, which structure requires that the fund have a single net asset value for each class and series of shares, rather than separate capital accounts for each investor.¹³ New investors purchase shares in the hedge fund at the then-current net asset value, which rises and falls according to the value of the underlying assets, and with the assessment of performance fees. Because the performance fees are charged to the fund as a whole and thus affect the value of each share in a similar way, an investor could be potentially disadvantaged or advantaged relative to other investors, depending on the timing of their initial investment. For example, an investor who purchases shares shortly before the assessment of performance fees will bear the full weight of such fees, without the opportunity to reap the benefits of gains accrued prior to the purchase.

There are a number of approaches hedge funds can take to "equalize" shares purchased at different times.¹⁴ One solution is to apply either a "equalization credit" or "depreciation deposit" to shares purchased. If the purchase is made when shares have decreased in value since the last assessment of fees, the investor agrees to pay a performance fee if the fund makes up the lost ground, even though other investors might not pay a fee. Conversely, if the purchase is made when shares have increased in value since the last high water mark, the investor should equitably receive an equalization credit (based on the performance fee multiplied by the increase in net asset value since the last high water mark), so that the next assessment of performance fees does not impact the new investors to the same degree as it would the existing investors.

An alternative approach is to issue a new series of shares each time the fund accepts new investments, and to assess performance fees separately for each such series.¹⁵ In order to avoid an unmanageable number of different share series, the different series issued in the course of a fiscal year are converted into a single series at the end of that year (when the performance fee is

¹² DOUGLAS L. HAMMER ET. AL., U.S. REGULATION OF HEDGE FUNDS, (2005).

¹³ *Id.*

¹⁴ LEDERMAN, *supra* note 9, §2:4:5.

¹⁵ *Id.*

assessed) by issuing “equalization shares” to investors holding shares at a higher net asset value than the “equalized” net asset value.

Portfolio Valuation and Fair Valuation

Determining the net asset value of a hedge fund and valuing individual assets comprising a hedge fund is critically important to the operation and administration of the fund. The fund manager has a strong interest in an accurate valuation of the portfolio. A precise evaluation of the fund’s positions allows the portfolio managers to make informed investment decisions. Furthermore, any management or performance fees are usually based on changes to the value of the fund’s portfolio. Perhaps most importantly, accurate valuation helps the fund manager minimize vulnerability to breach of fiduciary duty claims (as discussed herein). Although securities laws do not require fund managers to use any one particular valuation methodology, robust valuation policies and procedures and comprehensive disclosure of the same will likely enable the fund to avoid accusations of false and misleading statements in violation of Advisers Act rule 206(4)-8.¹⁶

In the interest of promoting industry-wide consistency, some industry organizations have described “best practices” for the hedge fund industry, and have identified characteristics of what they consider to be well-developed valuation policies and procedures. Examples of such best practices include, among others, (i) governance (clearly identifying the parties responsible for ensuring compliance with valuation procedures), (ii) independence (keeping the valuation process separated from trading and investment processes), (iii) periodic review of valuation procedures (including back-testing of selected valuations), (iv) consistency of practices over time, and (v) comprehensive policies embodied in written documents.¹⁷

A well-drafted set of fund documents should contain details of how the fund intends to value its assets, describing the accounting principles followed (usually GAAP), the frequency with which valuations will be made, the valuation methods the fund expects to use, and any exceptions to the rule (such as amortization of start-up costs). A fund may use different valuation methodologies, as some methods are more suited to certain asset classes than others. For example, publicly-traded equity holdings may usually be valued according to the last known transaction price. There may not, however, be accurate or recent pricing information at hand for more illiquid, infrequently traded assets. As a consequence, the party responsible for valuing such assets may have to make a determination as to the asset’s “fair value”.

A primary source of recent guidance with respect to fair valuation questions comes from the Financial Accounting Standards Board via their Statement of Financial Accounting Standards No. 157 (“FAS 157”).¹⁸ Under FAS 157, the “fair value” of an asset is defined as “the price that

¹⁶ LEDERMAN, *supra* note 9, §8:4:3.

¹⁷ REPORT OF THE ASSET MANAGER’S COMMITTEE TO THE PRESIDENT’S WORKING GROUP OF FINANCIAL MARKETS, *Best Practices for the Hedge Fund Industry*, April 15, 2008; *See also* LEDERMAN, *supra* note 9, §8:4:3.

¹⁸ FAIR VALUE MEASUREMENTS, Statement of Financial Accounting Standards No. 157, as amended (2008).

would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”¹⁹ Since there may not always be any actual market participants who stand ready and willing to effect such an “orderly transaction”, FAS 157 goes on to establish a hierarchy of “inputs” which funds may use to determine the fair value of their assets. Level 1 inputs include “observable” inputs such as unadjusted quoted prices in active markets. Level 2 inputs include quoted prices for identical assets in markets that are not active, or quoted prices for similar assets. Level 3 inputs (the lowest on the hierarchy) include “unobservable inputs” such as an entity’s internally derived data or the fund manager’s assumptions and projections as to asset value. FAS 157 requires that fair valuation procedures, to the extent commercially reasonable, attempt to maximize the use of observable inputs and minimize the use of unobservable inputs. In other words, taken at face value, FAS 157 appears to require that hedge funds use market quotations where possible.

In the wake of recent market turmoil, both FASB and the SEC have sought to add clarity for hedge funds and other entities valuing illiquid or thinly-traded assets. In September, 2008, the SEC’s Office of the Chief Accountant and FASB issued a joint release entitled “Clarifications on Fair Value Accounting” offering further guidance on the use of management’s internal assumptions to measure fair value.²⁰ According to the release, “when an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable.”²¹ Although FAS 157 establishes a hierarchy of inputs used to value assets, the 2008 release suggests that using unobservable inputs, such as management assumptions, might on occasion be more appropriate than using observable inputs.²² The SEC’s clarification on the operation of FAS 157 restores a certain degree of discretion with the entity performing fair valuation, insofar as the 2008 release concedes that “[t]he determination of fair value often requires significant judgment.”²³ The primary criterion as to whether the use of a particular input is appropriate is determined by “the extent to which [the inputs] provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.”²⁴ More recently, FASB has issued a number of Final Staff Positions (“FSP”) which set forth guidelines for determining whether there has been a “significant decrease” in the volume and level of activity for a particular asset.²⁵ If conditions suggest that there has in fact been a significant decrease in volume and activity, adjustments to transaction or quoted prices may be necessary to estimate the fair value of an asset.

¹⁹ *Id.*

²⁰ SEC Release 2008-234, *Clarifications on Fair Value Accounting*, Office of the Chief Accountant and FASB Staff (September 30, 2008).

²¹ *Id.*

²² *Id.* An example of a situation where unobservable inputs might be more appropriate is any case in which “significant adjustments” would be required to available observable inputs.

²³ *Id.*

²⁴ *Id.*

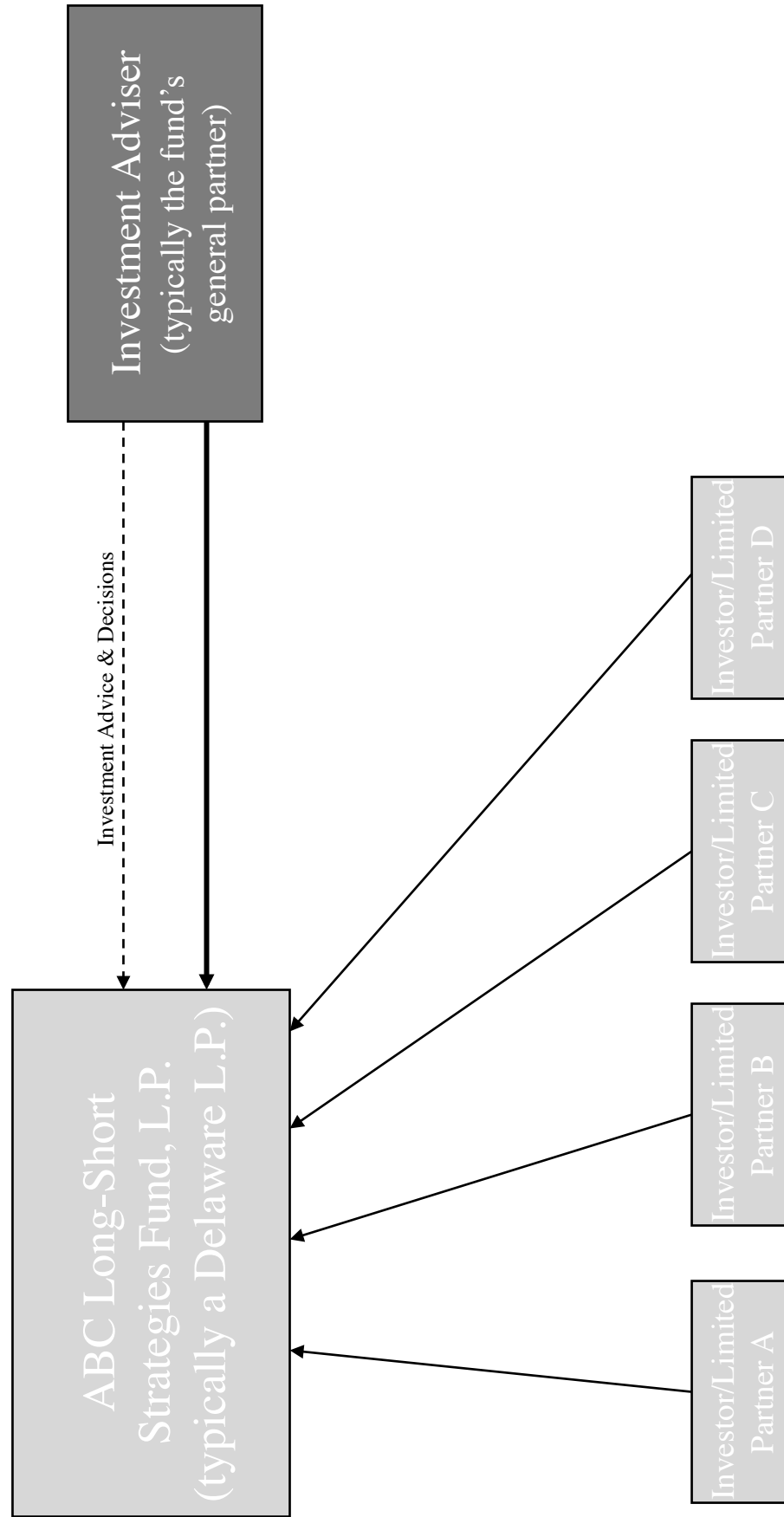
²⁵ FSP FAS 157-4

Diagrams

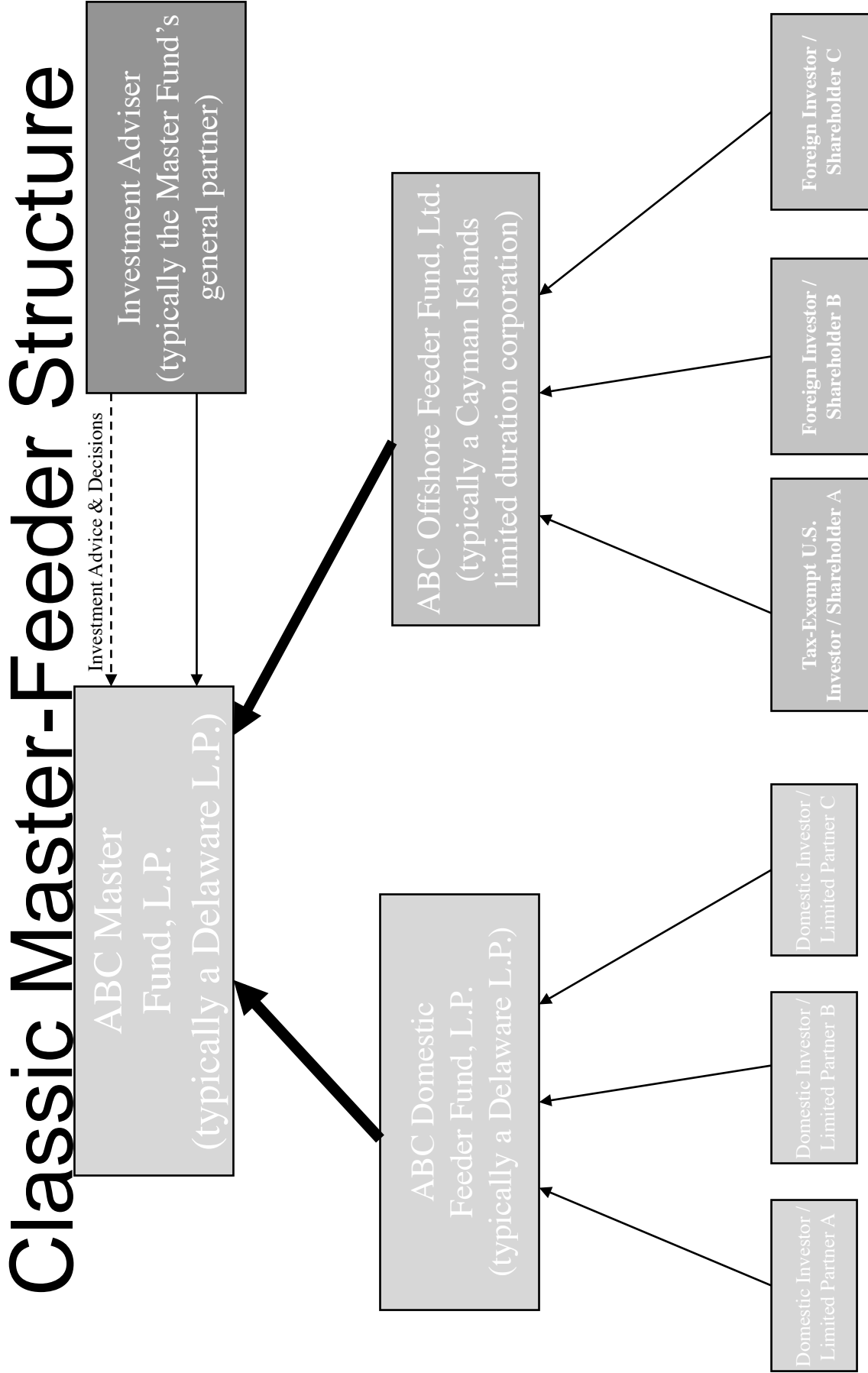
Attached hereto are diagrams of common hedge fund structures.

*solid lines represent capital investments

Domestic Standalone Hedge Fund

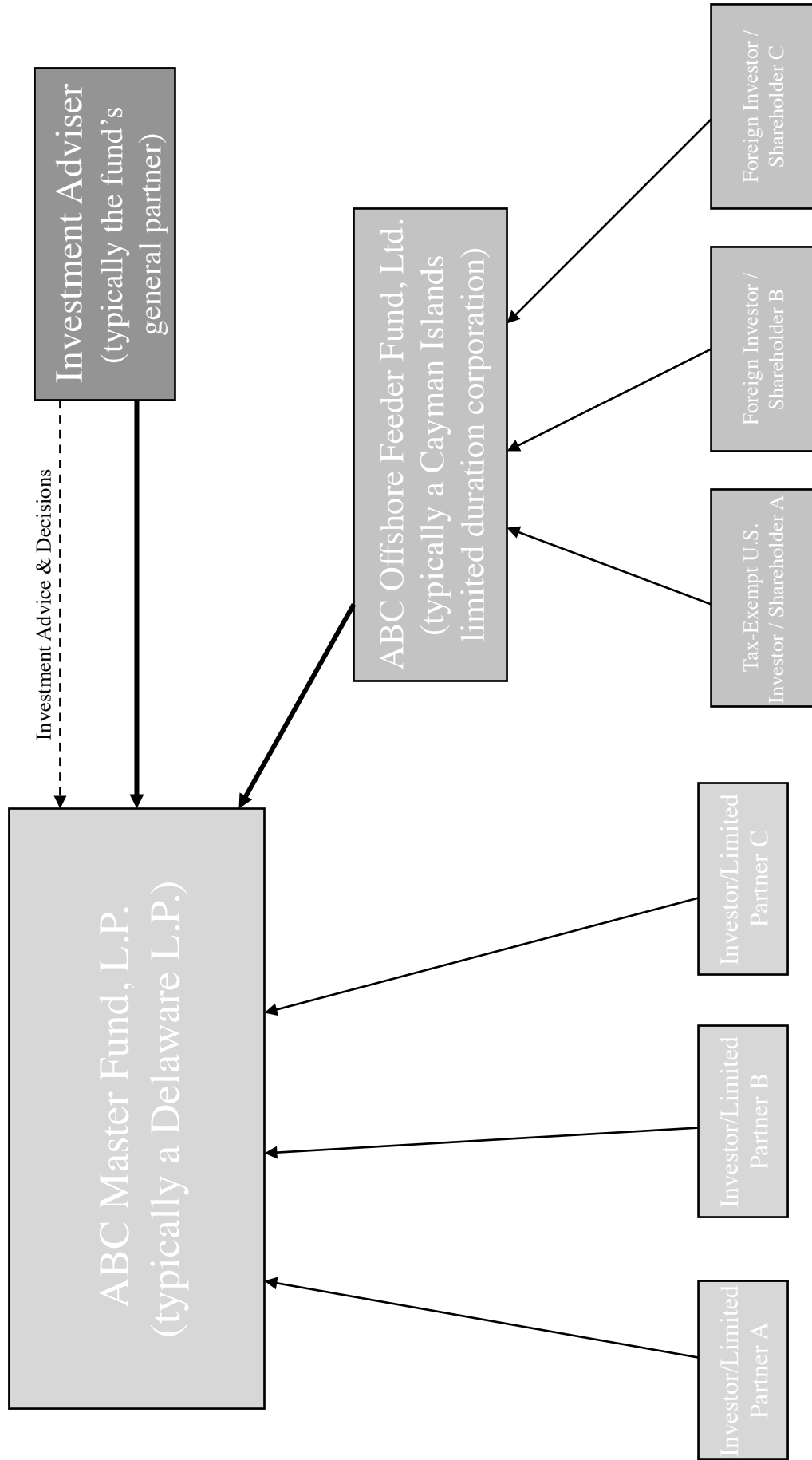


*solid lines represent capital investments



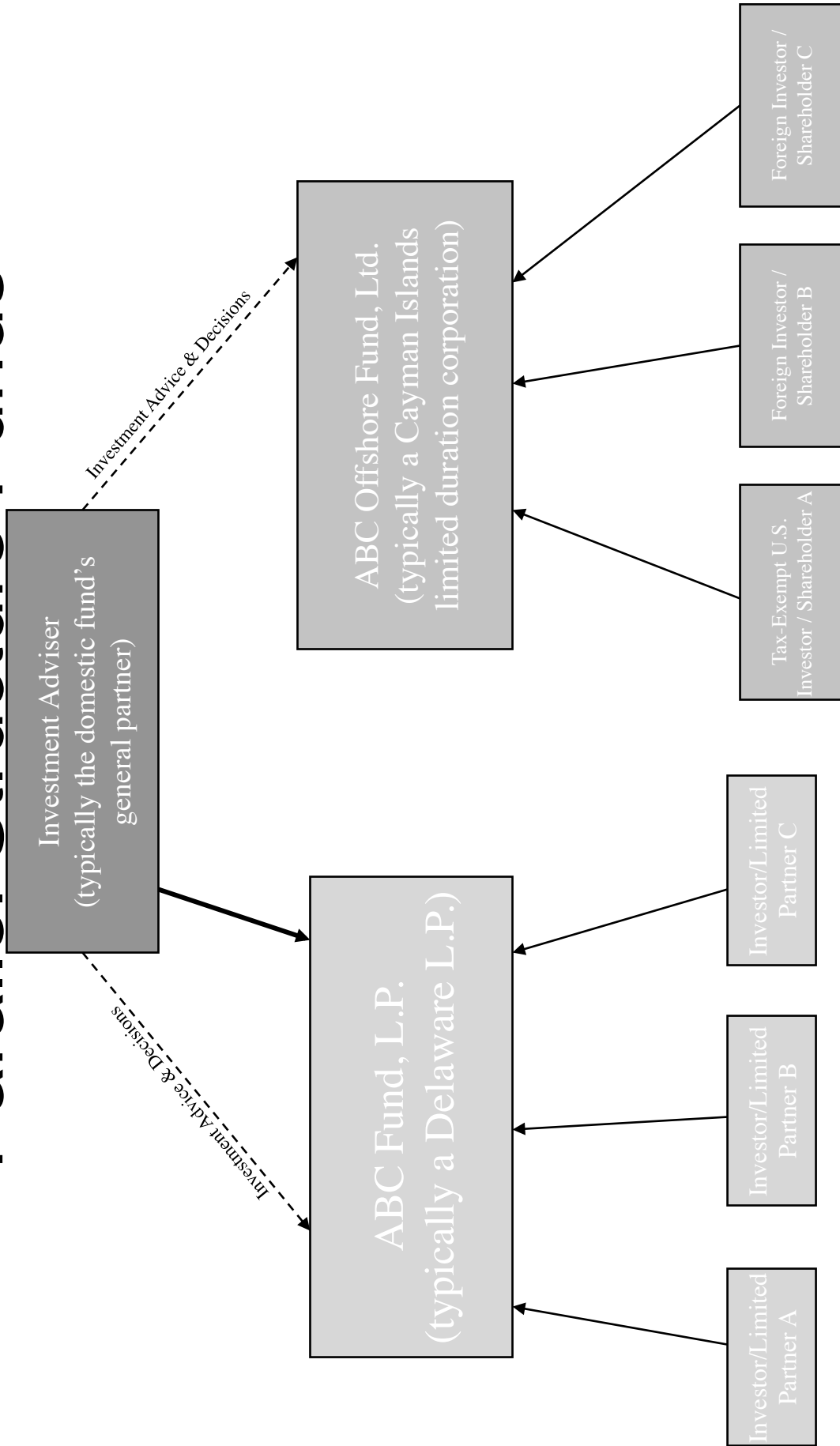
*solid lines represent capital investments

Mini-Master Structure



*solid lines represent capital investments

Parallel Structure Funds



How Does Chapter 15 Apply?¹

I. Chapter 15 Overview

History and Sources

Chapter 15 of the United States Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.* was enacted as part of a wider set of reforms known as the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”).² The new Chapter 15 replaces and expands upon the former §304 of the Bankruptcy Code, which had been enacted in 1978 to provide representatives in foreign bankruptcy proceedings an avenue to U.S. courts.³ In addition to serving as the successor to the former §304, Chapter 15 also represents the adoption, to a significant extent, of the Model Law on Cross-Border Insolvency (the “Model Law”) promulgated by the United Nations Commission on International Trade Law (“UNCITRAL”) in 1997.⁴ Drafted against a backdrop of accelerating globalization, the Model Law responds to a common interest in harmonizing cross-border insolvency regimes. Except for a few key differences, many of the provisions of the Model Law appear in Chapter 15 without material revisions.⁵

Purpose, Scope and Procedure

One of the stated objectives of Chapter 15 is the “fair and efficient administration of cross-border insolvencies that protects the interests of all creditors, and other interested entities, including the debtor.”⁶ To accomplish this, Chapter 15 allows a foreign representative to seek an order recognizing one or more foreign proceedings as the main proceedings for the liquidation of a non-U.S. entity. The foreign representative may initiate this process by filing a petition for recognition directly with a U.S. court.⁷ Evidence must accompany the petition for recognition, in the form of (1) a certified copy of the decision commencing the foreign proceeding and appointing the foreign representative, (2) a certificate from a foreign court affirming the existence of the proceeding and appointment of the representative, or (3) absent such

¹ Authored by Charles A. Dale III, Mackenzie L. Shea, Matthew P. O’Connor, and Kevin T. Teng of K&L Gates, LLP.

² Aaron L. Hammer and Matthew E. McClintock, *Understanding Chapter 15 of the United States Bankruptcy Code: Everything You Need To Know About Cross-Border Insolvency Legislation in the United States*, 14 LAW & BUS. REV. AM. 257, 262 (2008).

³ Alesia Ranney-Marinelli, *Overview of Chapter 15 Ancillary and Other Cross-Border Cases*, 82 AM. BANKR. L. J. 269 (2008). Ranney-Marinelli also notes that “cases decided under §304 remain relevant in construing 11 U.S.C. §1507, which incorporates elements of the former §304(c).”

⁴ Hammer and McClintock, *supra* note 1 at 258.

⁵ *Id.*

⁶ 11 U.S.C. §1501(a)(3).

⁷ *See* Hammer and McClintock, *supra* note 1 at 265.

certification, “any other evidence acceptable to the court of the existence of such foreign proceeding and appointment of such foreign representative.”⁸

Recognition as Foreign Main or Nonmain Proceeding

Recognition of a foreign main proceeding under Chapter 15 makes certain forms of relief (such as the automatic stay provisions of §362) immediately available, the effect of which is to stay actions brought in the United States against the foreign entity. Recognition also renders the foreign representative eligible to sue or be sued in the United States, to apply directly to a U.S. court for relief, and to request “comity or cooperation” from the U.S. court.⁹ It is important to note, however, that, in contrast to domestic bankruptcy proceedings where certain protections become available upon the filing of a petition, many of the rights and benefits afforded by Chapter 15 to foreign applicants do not immediately apply, and will be granted only upon entry of an order granting recognition of the foreign proceeding.¹⁰

The order granting recognition, in turn, may be entered by a U.S. court only after “notice and a hearing.”¹¹ The key prerequisite to the order granting recognition lies, however, in Chapter 15’s definition of “recognition”. As set forth in §1502, the term recognition applies *only* to a “foreign main proceeding” or a “foreign nonmain proceeding” under Chapter 15. In other words, access to the automatic stay and other provisions of the U.S. Bankruptcy Code and the cooperation of U.S. courts is contingent upon the foreign representative demonstrating that the proceeding is either a foreign main or foreign nonmain proceeding.¹² Absent such a demonstration, the foreign representative’s options for relief in U.S. courts are severely limited.

If a proceeding is recognized as a foreign main proceeding, certain provisions of the Bankruptcy Code automatically apply pursuant to § 1520. These provisions permit the foreign representative to receive the benefit of the automatic stay; to operate the debtor’s business and exercise the rights of a trustee under § 363 and 552 of the Bankruptcy Code; to avoid post-petition transfers under § 549; and to use, sell, or lease some or all of the debtor’s U.S. assets.¹³ In contrast, if a proceeding is recognized as a foreign nonmain proceeding, these forms of relief are only available if “the interests of the creditors and other interested entities, including the debtor, are sufficiently protected.”¹⁴ In both instances, however, the court may “provide additional assistance to a foreign representative under [Title 11] or under other laws of the United States”

⁸ 11 U.S.C. §1515(b).

⁹ Hammer and McClintock, *supra* note 1 at 268.

¹⁰ Ranney-Marinelli, *supra* note 2 at 281.

¹¹ 11 U.S.C. §1517(a).

¹² See Ranney-Marinelli, *supra* note 2 at 284, citing H.R. REP. NO 109-32 (2005) at 112-113 (noting that the “ultimate burden of proof as to each element of recognition is on the foreign representative.”).

¹³ See 11 U.S.C. §1520.

¹⁴ See 11 U.S.C. § 1522(a).

so in this regard, the court has discretion to order additional forms of relief.¹⁵ Further, upon recognition of a foreign proceeding, whether main or nonmain, “where necessary to effectuate the purpose of [Chapter 15] and to protect the assets of the debtor or the interests of creditors,” the court may provide certain enumerated forms of relief. These include (1) staying an action, proceeding, or execution against the debtor’s assets, rights, obligations, or liabilities; (2) suspending the right to transfer, encumber, or otherwise dispose of the debtor’s assets; (3) providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor’s assets, affairs, rights, obligations or liabilities; (4) entrusting the administration or realization of all or part of the debtor’s U.S. assets to the foreign representative or another person, including an examiner, authorized by the court; or (5) granting any additional relief that may be available to a trustee, except for so-called avoidance powers.¹⁶ Notably, a foreign representative may only commence avoidance actions if a full Chapter 11 case is subsequently filed, something that is expressly authorized if the proceeding is recognized as a foreign main proceeding.¹⁷

The court’s determination as to whether there is a foreign main or nonmain proceeding is far from automatic. According to Chapter 15, a “foreign main proceeding” refers to a “foreign proceeding filed in the country where the debtor has the center of its main interests.”¹⁸ The concept of the debtor’s ‘center of main interests’ (frequently abbreviated as “CoMI”) is generally equated with the concept of a ‘principal place of business’ in U.S. law.¹⁹ By way of additional guidance, Chapter 15 also 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 center of the debtor’s main interests.”²⁰

Even if the debtor is unable to demonstrate that the foreign proceeding is pending where the debtor’s CoMI is located, Chapter 15 still allows for recognition of foreign nonmain proceedings. There are, however, some key differences between foreign main and nonmain proceedings. A foreign proceeding will be characterized as “nonmain” if the proceeding is pending in a country where the debtor has an “establishment.”²¹ Unlike CoMI, establishment is explicitly defined in Chapter 15, and refers to “any place of operations where the debtor carries out a nontransitory economic activity.”²² More importantly, Chapter 15 relief in a foreign nonmain proceeding is available only on a discretionary basis, rather than as a matter of right (as

¹⁵ 11 U.S.C. § 1507(a).

¹⁶ 11 U.S.C. § 1521(a).

¹⁷ *See* 11 U.S.C. § 1520, 1523.

¹⁸ 11 U.S.C. §1502(4).

¹⁹ Ranney-Marinelli, *supra* note 2 at 285.

²⁰ 11 U.S.C. §1516(c).

²¹ 11 U.S.C. §1502(5).

²² 11 U.S.C. §1502(2).

would be the case in a foreign main proceeding).²³ Furthermore, foreign representatives in nonmain proceedings may not commence bankruptcy cases under other chapters of the Bankruptcy Code.²⁴

II. Chapter 15 and Offshore Hedge Funds

As Alesia Ranney-Marinelli notes, CoMI determinations have been non-controversial in “the vast majority of Chapter 15 cases to date.”²⁵ Offshore hedge funds, such as those constituting the “offshore” portion of a master-feeder or parallel fund structure, present certain unique questions, such as the weight to be given to the location of the debtor’s registered office. A number of recent Chapter 15 cases involving offshore funds have cast some doubt on the ability of such funds to obtain recognition. In the case of *Bear Stearns High-Grade Structured Credit Strategies Master Fund* (2007), the court was presented with petitions for recognition on behalf of entities registered in the Cayman Islands.²⁶ Each of these entities was registered as an exempted company under Section 193 of the Cayman Companies Law, and as such, was precluded from engaging in business in the Cayman Islands, except in furtherance of their business carried on outside the Cayman Islands.²⁷ Despite this fact, pursuant to the presumption described above, the foreign representatives could have taken the position that recognition of a foreign main proceeding was proper, since each debtor entity in question had registered offices in the Cayman Islands.

Senior Bankruptcy Judge Burton R. Lifland, who presided over the *Bear Stearns* proceedings, however, took a very different view of the presumption and the effect of the fund’s registered office being located offshore. On the one hand, the entity in question was registered in the Cayman Islands, and there were no objections by any investors or creditors to the petition for Chapter 15 recognition.²⁸ On the other hand, the fund’s administrator was a Massachusetts corporation, the investment manager was located in New York, there were no employees or managers in the Cayman Islands, and the accounts receivable were located throughout Europe and the United States.²⁹ Reviewing the fund’s various connections, and in light of the fact that Cayman Companies Law required the fund to conduct its primary business outside the Cayman Islands, the court found that the CoMI was more properly located in the United States, and consequently denied the petition for recognition of a foreign main proceeding. Turning to the question of whether there was a foreign nonmain proceeding, the court chose to interpret “establishment” as a “local place of business.” Once again, in light of the fund’s minimal contacts in the Cayman Islands, the court refused to recognize the Cayman proceedings as

²³ Hammer and McClintock, *supra* note 1 at 269.

²⁴ *Id.*

²⁵ Ranney-Marinelli, *supra* note 2 at 286.

²⁶ *See In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007).

²⁷ *See* Ranney-Marinelli, *supra* note 2 at 287.

²⁸ Hammer and McClintock, *supra* note 1 at 273.

²⁹ *Id.*

foreign nonmain proceedings under Chapter 15.³⁰ Although an appeal was entered, the Southern District of New York upheld the Bankruptcy Court's decision to deny recognition.³¹ Because it is not unusual for offshore funds to have servicing agreements and management agreements with parties domiciled in the United States, and in light of the fact that fund assets are often held by a U.S. custodian, the *Bear Stearns* decision suggests that courts are unlikely to mechanically rubberstamp petitions for recognition filed on behalf of offshore hedge funds.

³⁰ Ranney-Marinelli, *supra* note 2 at 297.

³¹ See *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 2008 WL 2198272 (S.D.N.Y. May 27, 2008).