

## **The Reticent Nature of Hedge Funds vs. the Open, Public Process of Cases Under the U.S. Bankruptcy Code**

Hedge funds generally tend to be reticent in nature, particularly regarding their investors, holdings and trading strategies. In contrast, cases brought under the U.S. Bankruptcy Code are an open, public process, where full disclosure of legal rights, claims, relationships among parties and potential conflicts is expected as a matter of due course. A number of recent bankruptcy cases provide ample evidence that these conflicting dynamics are butting directly up against each other. A look at some rulings in recent cases involving hedge funds as both debtors and creditors strongly suggests that, even as Congress, the SEC and other federal regulators continue to debate hedge fund regulation, some bankruptcy judges appear to be filling the void with rulings designed to force hedge funds that are appearing in cases before them into a more transparent mode.

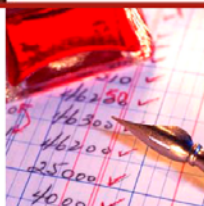
### **HEDGE FUNDS AS DEBTORS**

On April 30, 2008, Judge Robert Gerber of the U.S. Bankruptcy Court for the Southern District of New York signed an order dismissing the Chapter 15 case of Basis Yield Alpha Fund (“the Fund”). The dismissal was made at the request of the Cayman Island Joint Provisional Liquidators (JPLs) of the Fund, following Judge Gerber’s refusal to recognize the Fund’s Cayman liquidation proceeding as a “foreign main proceeding” under Chapter 15 of the U.S. Bankruptcy Code.

The Fund commenced the Cayman liquidation proceeding in August 2007 and shortly afterwards, the JPLs filed a petition for recognition under Chapter 15 in the Southern District of New York, which essentially would have provided protection to its U.S. assets while its liquidation was overseen by the Cayman courts. Although no objections to the requested relief were made, Judge Gerber denied Chapter 15 recognition to the Fund, citing an absence of evidence sufficient to convince the court that the Fund’s “center of main interest” (COMI) was in fact in the Caymans. The JPLs were subsequently directed to show detailed information not only about the Fund’s assets, creditors and employees, but also about the number and location of the Fund’s equity investors and the relative percentages of the applicable equity held by investors in each locale.

Rather than presenting the information requested, the JPLs contended in a subsequent motion that, as a matter of law, the Fund was entitled to recognition in the Caymans, citing a provision of Chapter 15 that sets forth a presumption that a petitioning debtor’s COMI is based on the location of its registered office. Judge Gerber disagreed, however, and reiterated his request for the information. The JPLs instead asked to have the case dismissed.

This decision followed the similar ruling last year by Judge Burton Lifland in cases involving the Bear Stearns High-Grade Structured Credit Strategies Master Fund and the Bear Stearns High-Grade



Structured Credit Strategies Enhanced Leverage Master Fund. Judge Lifland denied the request of the Bear Stearns funds to have their Cayman Island liquidations recognized under Chapter 15, finding that the funds' Cayman presence amounted to little more than a "letter box," and making clear his view that the court was not going to "rubber stamp" the funds' petitions in order to facilitate their wind-down outside of the United States. That decision is currently on appeal.

### **HEDGE FUNDS AS CREDITORS**

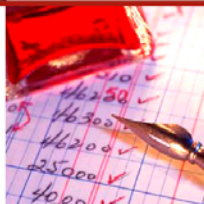
Rule 2019 of the Federal Rules of Bankruptcy Procedure require certain disclosures by "every entity or committee representing more than one creditor or equity security holder[.]" A highly contentious issue has recently arisen as to whether Rule 2019 can be used to require members of ad hoc committees (which often consist of hedge funds) in Chapter 11 cases to disclose the amount that they paid to acquire their claims or interests.

Last year, in the Northwest Airlines case, Judge Alan Gropper of the Southern District of New York held that a group of hedge fund equity holders represented by common counsel constituted a "committee" for purposes of Rule 2019. The equity holders were therefore required to provide information setting forth "the amount of claims or interests owned by the members of the committee, the times acquired, the amounts paid therefor, and any sales or dispositions thereof[.]" Although Judge Richard Schmidt in the Pacific Lumber Chapter 11 case subsequently reached the opposite conclusion on this question and refused to require an ad hoc group of bondholders to disclose details of their trades of Pacific Lumber debt securities, during a recent hearing in that case he indicated that he may revisit that ruling (perhaps reflecting his frustration with the extraordinarily contentious nature of the plan confirmation battle). Also, Judge Kevin Carey in the highly influential Delaware bankruptcy court is expected shortly to issue a ruling on a Rule 2019 request in the Sea Containers Chapter 11 case.

The amount paid for a claim or interest is irrelevant to its treatment in bankruptcy. However, for a hedge fund, such information can be tantamount to disclosing a proprietary trading strategy. Unquestionably, some debtors and other interested parties are requesting such disclosures as a way to seek to neutralize an aggressive group of hedge funds and perhaps create pressure for a settlement.

### **CONCLUSION**

Continuing financial market volatility means that there will be more hedge fund failures that will need to be resolved, and hedge funds are playing major roles as creditors in most significant Chapter 11 cases. The decisions above strongly suggest that in such cases, many bankruptcy court judges are going to be insistent on obtaining disclosures that they deem necessary to the relief being sought – regardless of how reluctant the hedge funds might be to have such information made public.



## FOR MORE INFORMATION

For more information on this topic, please contact:

Katherine D. Brandt	212.908.3915	<b><a href="mailto:Katherine.Brandt@ThompsonHine.com">Katherine.Brandt@ThompsonHine.com</a></b>
Martin Eisenberg	212.908.3933	<b><a href="mailto:Martin.Eisenberg@ThompsonHine.com">Martin.Eisenberg@ThompsonHine.com</a></b>
Benjamin D. Feder	212.908.3953	<b><a href="mailto:Ben.Feder@ThompsonHine.com">Ben.Feder@ThompsonHine.com</a></b>
Richard S. Heller	212.908.3907	<b><a href="mailto:Richard.Heller@ThompsonHine.com">Richard.Heller@ThompsonHine.com</a></b>
James P. Jalil	212.908.3976	<b><a href="mailto:James.Jalil@ThompsonHine.com">James.Jalil@ThompsonHine.com</a></b>
Alan R. Lepene	216.566.5520	<b><a href="mailto:Alan.Lepene@ThompsonHine.com">Alan.Lepene@ThompsonHine.com</a></b>

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