

## Stillwater Runs Deep For Investment Redemptions

Law360, New York (March 12, 2013, 1:10 PM ET) -- In one of the first decisions from a United States court involving alleged overreaching by an offshore fund, the Bankruptcy Court for the Southern District of New York, in *In re Stillwater Asset Backed Offshore Fund Ltd.*, 2013 Bankr. LEXIS 226, 57 Bankr. Ct. Dec. 127 (Bankr. S.D.N.Y. Jan. 17, 2013, Bankruptcy Judge Allan Gropper), recently denied a motion by the putative debtor, an offshore fund incorporated in the Cayman Islands, to dismiss an involuntary petition filed under the U.S. bankruptcy laws.

This ruling, as discussed below, adds to a limited body of case law, predominantly from Cayman courts, relating to the mistreatment of creditors of an offshore fund with assets in the United States. Additionally, Judge Gropper cites Cayman law in reaching the holding, making this the first significant decision in 10 years discussing the impact of Cayman law on such proceedings and applying it to distributions in kind. Both aspects of this decision are particularly significant in light of the increase in Chapter 15 filings over the course of the past 12 months dealing with foreign offshore funds related to entities with assets in the United States. With the liquidity crisis ongoing, courts are likely to see more challenges of this sort by creditors in the future.

In the way of background, the putative debtor, Stillwater Asset Backed Offshore Fund Ltd., was organized under the laws of the Cayman Islands as an offshore investment company. All of Stillwater's investments were in participation interests in assets held by an onshore fund organized under Delaware law. Both fund entities were managed by the same principals. Stillwater's participation interests were documented by a series of identical master loan participation agreements with the onshore fund.

Following the financial crisis in 2008, the petitioning creditors redeemed all of their remaining investments in Stillwater, rendering them creditors of Stillwater. Unable to pay cash, Stillwater attempted to satisfy this debt through a distribution in kind of interests in participations in the onshore fund's investments. The only documents that Stillwater issued in connection with this distribution in kind were (i) an assignment and participation certificate and (ii) a share transfer form. The onshore fund failed to provide or execute any documentation establishing the onshore fund's recognition of these redeeming investors as direct participants in the assets with the same rights as Stillwater.

One month later, Stillwater executed an asset purchase agreement and the onshore fund entered a merger agreement, effectively selling all of their assets to a Bermuda hedge fund, Gerova Financial Group Ltd. (pending in Chapter 15 before the same bankruptcy court). Stillwater's creditors received nothing as a result of this transaction. The petitioning creditors were offered interests in Gerova as a substitution for the property supposedly transferred through the distribution in kind, which the petitioning creditors rejected.

Stillwater maintained that, following the transaction, the petitioning creditors had an interest in investments now owned by Gerova. No evidence, however, existed to establish that Gerova recognized these interests. The petitioning creditors never received an accounting of their supposed holdings or any payment.

Over a year later, both Stillwater and its investors remained empty handed, having never received anything of value from the Gerova transaction. The transaction collapsed and Stillwater did not receive the bargained-for Gerova stock. At that point, Stillwater and Gerova signed a letter of intent to unwind the transaction.

To date, almost two years after the letter of intent was executed, the unwind has yet to happen. Adding to the complications, Gerova is subject to a winding up proceeding in Bermuda and a related Chapter 15 proceeding in the Bankruptcy Court for the Southern District of New York. On Oct. 4, 2012, the petitioning creditors filed an involuntary Chapter 11 bankruptcy proceeding against Stillwater in the same court.

Stillwater filed a motion to dismiss the involuntary proceeding on the grounds that the debts to the petitioning creditors were satisfied in full through the distribution in kind. Stillwater contended that the

proceeding cannot go forward because an involuntary petition can only be filed by three or more creditors holding claims that are not subject to a bona fide dispute. Stillwater argued that the petitioning creditors are not creditors and, even if they are, their debt was subject to a bona fide dispute.

The court rejected Stillwater's argument, holding that no bona fide dispute existed because the distribution in kind did not satisfy Stillwater's debt to the petitioning creditors. The court explained that "[i]nstead of the delivery of a security that the Alleged Debtors held in its portfolio, or even something that could be called an 'asset in specie,' the Petitioning Creditors received an equity interest in (i) a new fund set up to hold some of the investments made by the Alleged Debtors and (ii) an undivided interest in the Alleged Debtor's participations in some of the investments made by the onshore fund." Stillwater, 2013 Bankr. LEXIS 226, \*19.

The court held that, as to the new fund, the petitioning creditors had "at most, no more than they had before — a claim against assets of the Alleged Debtor for amounts owed them on account of their redemptions." Id. Stillwater had "merely [] dedicate[ed] ... its assets to the payment of debts," it had not actually paid them. Id.

In reaching this conclusion, the court followed authority from Judge Robert Gerber's much earlier decision in *In re Paper I Partners LP*, 283 B.R. 661 (Bankr. S.D.N.Y. 2002), and authority from the Cayman Islands in *In re FIA Leveraged Fund*, (April 18, 2012) No. FSD 0013 of 2012 at p. 26-28 (ASCJ) (Cayman Is.) (appeal pending).

The court further opined: "the proposition cannot be sustained that the Petitioning Creditors received portfolio securities or a 'distribution in kind' by the transmittal of a piece of paper that purported to give them a slice of some of the Alleged Debtor's investments. Indeed, as holders of a purported investment slice, the Petitioning Creditors seemingly had less than they would have had as creditors of Stillwater." Stillwater, 2013 Bankr. LEXIS 226, \*21. Additionally, the "assets ... by their terms [could not] be further subdivided." Id.

The Stillwater decision raises several issues which may have impact for future investment redemptions.

First, the ruling provided that parties may not satisfy redemption requests through transferring equity interests in a new "special purpose" entity containing assets set aside for payment of a debt as a substitution for actually paying that debt.

Second, under this decision, parties may not satisfy share redemption requests through the transmittal of a piece of paper that purports to transfer a slice of the investments in contravention of the terms of such investments prohibiting subdivision, without more.

Third, and finally, the case highlights the necessity of thorough documentation and transmittal of all paperwork required to establish ownership (and the necessary accompanying rights) of the distributed assets for an effective distribution in kind.

While every case is fact specific, given the vacuum of law in the United States analyzing creditors' rights in offshore funds, and uptick in Chapter 15 proceedings, the Stillwater decision provides an up-to-date review of these issues from the perspective of one U.S. Bankruptcy Court.

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