

APPLEBY

Successfully resolving high profile and complex cases is not down to chance. It takes skilled lawyers, who understand their clients' needs and deliver objective advice with unparalleled responsiveness – especially when there's more than one jurisdiction to think about. Experienced litigation counsel providing trusted guidance **Appleby.**

applebyglobal.com

THE RIGHT PEOPLE. THE RIGHT PLACES.
THE RIGHT GUIDANCE.

Bermuda

British Virgin Islands

Cayman Islands

Hong Kong

Jersey

London

Mauritius

Zurich

Offshore Legal, Fiduciary
& Administration Services



Hedge fund redemption rights

Keith Robinson of Appleby follows a case study of hedge fund litigation to demonstrate Bermuda's litigation scene

The global economic downturn has undoubtedly had an effect on the British Overseas Territory of Bermuda, its people and some of the many overseas companies known as Exempt Companies that are domiciled in Bermuda. As illustrated below, these impacts have begun to be felt in the case law of Bermuda courts.

While Bermuda is small in terms of its geographic size and its population (more than 100 islands measuring 21 square miles and approximately 63,000 people), a very significant number of exempt companies are registered by the Bermuda Registrar of Companies. As of June 2008 this number stood at 13,763. Bermuda is the second biggest reinsurance market after New York, and many major US corporations maintain Bermuda registered companies in their structure. In addition, as of 2007 approximately 40% of the main board of the Hong Kong Stock Exchange consisted of Bermudan Exempt Companies. While Bermuda is best known for its insurance industry, it is also a significant centre for funds and trusts.

Bermuda's principal trial court is the Supreme Court of Bermuda which includes a specialist Commercial Court division. The Supreme Court is bound by the decisions of the Court of Appeal of Bermuda. The Court of Appeal of Bermuda sits in session several times during a calendar year with Court of Appeal Justices being drawn mainly from the retired senior judiciary from a number of the British Commonwealth jurisdictions. The Court of Appeal of Bermuda is in turn bound by decisions of the Judicial Committee of the Privy Council on matters of Bermuda law. While Bermuda Courts are not hierarchically subordinate to the English House of Lords or other English Courts, the Bermuda Courts will accept the decisions of the House of Lords dealing with common law matters as well as those of the Privy Council on appeals from other jurisdictions as binding. This is subject to the caveat that the Bermuda Courts can theoretically deviate from an English House of Lords decision if "the social conditions of Bermuda make inappropriate the particular path of development chosen by the House of Lords against the background of British conditions."

A large number of Bermuda statutes are based on statutes that either currently or

previously applied in England and Wales. This is true of the Bermuda Companies Act 1981 which is largely based on the English Companies Act 1948. Therefore, the Courts of Bermuda will treat the decisions of the English courts as highly persuasive, in which similarly-worded statutory provisions were considered. The Courts of Bermuda also very commonly refer to, and treat as persuasive, the decisions on common law matters of courts of other countries in the British Commonwealth, principally Australia and Canada.

The Bermuda legal system is serviced by a relatively large legal profession with 352 barristers and attorneys now admitted. It is somewhat uncommon for counsel from other jurisdictions to be admitted to the Bermuda Bar to plead cases before the Supreme Court. The Supreme Court Act 1905 recognises that overseas counsel may be admitted to appear before the courts of Bermuda in any particular case or series of cases, but only where these involve questions of law or practice of considerable difficulty or public importance. As a matter of policy, the Bermuda Bar Association takes the position that litigation before the Bermuda courts should be conducted by local counsel and it will only support the admission of foreign counsel for particular cases when certain criteria are made out.

In addition to a fair amount of litigation which is local to Bermuda, it is unsurprising given the scope of the financial services industry in these islands that the Supreme Court of Bermuda often decides cases which could just as easily come before the High Court in London or the US District Court for the Southern District of New York. In terms of precedent value, perhaps the most notable decision to emanate from the Supreme Court of Bermuda in the last year is that of *In the*

Matter of Stewardship Credit Arbitrage Fund Ltd. The remainder of this article will focus on this decision as an illustration of the nature of the complex litigation which often comes before the Bermuda courts. The factual background to this case is probably an indication that the very difficult conditions in the world's credit markets will have an on-going impact on litigation in Bermuda for the foreseeable future.

Stewardship Credit Arbitrage Fund Ltd was a hedge fund facing an application by petition to wind-up the company. The grounds for the petition were both that Stewardship was insolvent and that it was "just and equitable" that Stewardship be wound-up.

The petition was presented by investors which were 'funds of funds' and was opposed by both Stewardship and Stewardship's principal bank lender. The petitioning investors had entered into various contracts to acquire shares in Stewardship and had then made a number of redemption requests in the course of late 2007 amounting to more than \$110 million. Stewardship had suspended the calculation of its net-asset value (NAV) and all subscriptions and redemptions in mid-2008 given that it could not withstand the large demand for redemption requests in the current market conditions.

Stewardship's bylaws provided that the board of directors could "in its discretion, settle redemptions, in whole or in part, in kind by distributing assets of the company having a value equal to the relevant redemption price to the redeeming member." Stewardship had tendered payment in kind to the redeeming investors in the form of participation notes. The features of these participation notes were evidence of beneficial ownership interests in a trust created by Stewardship for the purposes of pooling loans which were the subject of participation. The participation notes purported to be certificates, each referred to as a registered instrument, rather than a bearer instrument. The participation notes provided for payment to the holder upon receipt by Stewardship of any payment of principal or interest on the underlying loans. The participation notes were stated to be governed by the law of New York and they further prohibited transfer without the consent of Stewardship.

The winding-up petition before the Supreme Court was not in fact the first piece of litigation to arise out of the redemption

“As of 2007 approximately 40% of the main board of the Hong Kong Stock Exchange consisted of Bermuda-exempt companies”

Author biography



Keith Robinson
Appleby

Keith Robinson is an associate and a member of the litigation and insolvency practice group. His practice focuses on contentious trusts and estates as well as corporate insolvency and a range of commercial litigation.

Robinson draws on his extensive advocacy experience gained in more than 10 years of practice at the Northern Ireland Bar. He joined the group in January 2008 and has since then written extensively on a range of Bermuda law issues.

While in practice at the Northern Ireland Bar he appeared in a large number of reported cases in both the High Court and Court of Appeal. Several of these remain important authorities in Northern Ireland in trusts and estates and insolvency.

Robinson graduated from the University of Oxford with a First Class honours degree in Jurisprudence in 1993 and again with a Bachelors of Civil Law (First Class) in 1995. He was called to the Bar of Northern Ireland in 1996, the Bar of Ireland in 2000 and the Bermuda Bar in January 2009. He also holds Master of Laws degrees from the University of British Columbia, Vancouver, Canada and from New York University in international legal studies.

requests made by these investors. Having refused to accept the participation notes as a valid redemption in kind, the investors launched a debt action in the summer of 2008 and sought and were granted by the Chief Justice of Bermuda a worldwide Mareva injunction on foot of this action up to a value of \$110 million. Between the date of issue of this debt action and the presentation of the winding-up petition, Stewardship discovered that it had been the victim of a very significant fraud in the US. It appears from the report of this decision that a significant amount of the loans underlying the participation notes had been affected by this fraud.

Thus the investors changed tack and petitioned for the winding up of Stewardship and, as is very common in Bermuda, applied at the same time for the appointment of provisional liquidators. The decision of the trial judge deals with a number of legal issues of interest. The judge firstly considered and restated the grounds upon which the Bermuda court will appoint a provisional liquidator. The Companies Act 1981 provides a very broad discretion in Section 170 to make such appointment: “the court may on the presentation of a winding-up petition or at any time thereafter and before the appointment of a liquidator appoint a provisional liquidator who may be the official receiver or any other fit person.” The judge

followed earlier Bermudian and English authority holding that the test is that an applicant must “at least make out a good *prima facie* case that a winding-up order will be made.”

The judge then considered in some detail the legal status of the redeeming investors in order to determine whether they had ceased to be shareholders of Stewardship and were creditors who would thus be entitled to present a winding-up petition on the grounds that the company was unable to pay its debts. The judge first looked at the obligations on Stewardship when presented with a redemption request and when making a distribution in kind. The judge held that the bye-laws imposed obligation to distribute assets of the company having a value equal to the relevant redemption price. The judge took an extremely critical view of the participation notes holding, in effect, that they did not meet any of the requirements for a distribution in kind. The judge stated that he was “highly doubtful that the participation notes can properly be described as assets of the company, although in truth the stronger point is no doubt the value of those assets... It is clear that at the transfer date, there was no value in the participation notes.” It is difficult to see from the case report how the judge could have reached the conclusion that the participation notes were of no value on the affidavit evidence before him. In an extremely

robust decision the judge did not consider how the participation notes would have been viewed according to their governing law in New York, nor accept that it was even arguable that there had been a valid redemption in kind.

Having found that Stewardship had not made an effective redemption the judge then held that the investors were creditors of Stewardship stating that “whether the debt representing the redemption monies would be satisfied in cash or satisfied by the distribution of assets in kind, it remained a debt obligation.” In an interesting example of reliance on British Commonwealth authority by the Bermuda court, the judge appears to have found persuasive a first-instance decision of the New South Wales Supreme Court in *Basis Capital Funds Management Ltd v BT Portfolio Services Ltd*. In fact, only Australian authorities appear to have been relied on by counsel in the case on this point. In *Basis Capital Funds Management v BT Portfolio Services* the judge held that “once redemption has taken place, the position of the former unit-holder is transmuted from unit-holder to creditor, if the redemption price is unpaid.” The judge in *Stewardship* also considered in detail the argument put forward on behalf of Stewardship that in considering the status of the investors the NAV ought to be restated as at the redemption date given the fraud that had befallen the company. The judge held that there was no case to restate the NAV, not only on the facts (including the fact that the fraud was only discovered months after the redemption date), but also because in law Stewardship’s ignorance at the time of the fraud was not the effective cause of making a payment based on an incorrect NAV.

The judge in *Stewardship* also gave brief consideration to the argument that the winding-up petition should be dismissed since it was founded on a disputed debt. The orthodox position in both Bermuda and England is that a winding-up petition based on a debt which is disputed on some substantial ground is an abuse of process of the court and will be struck out or restrained as improper. Stewardship had open to it the argument that the investors who were now launching insolvency proceedings had themselves commenced an ordinary debt action and thus, having made that election, that it was improper to pursue the matter by way of a winding-up petition. The judge dismissed this argument on the basis that the discovery of the substantial fraud in the US after the commencement of the debt action changed the position and that the investors had thus not made an election for the relief available in the debt action – an order for the payment of the redemption price.

The judge then gave detailed considerations on the facts as to whether it could be said that Stewardship was insolvent. Under the Companies Act 1981, a company is deemed to be unable to pay its debts “if it

“The Supreme Court of Bermuda often decides cases which could just as easily come before the High Court in London or the US District Court for the Southern District of New York”

is proved to the satisfaction of the Court that the company is unable to pay its debts; in determining whether a company is unable to pay its debts, the court shall take into account the contingent and prospective liabilities,” according to Section 162(c). There are in effect two tests for insolvency, one based on the inability to pay debts as they fall due, the cash-flow test, and one based on a consideration of the assets and liabilities of the company, the balance-sheet test. The judge found on the facts that Stewardship was insolvent on the basis of both tests and he thus found that the test for the appointment of provisional liquidators was made out.

The matter did not rest there, however, since the judge also considered whether or not it was also appropriate to wind the company up on “just and equitable grounds.” This residual ground for the winding up of a Bermuda company can be traced back to a similar provision in England and Wales. A “just and equitable winding-up” is on occasion in Bermuda sought as a remedy in a petition by a minority shareholder of a company that is complaining of oppressive conduct against it. It is, however, extremely rare for this ground to be pursued by a creditor who is able to show that a company is insolvent. The judge in *Stewardship* followed English authority in *Re a Company* ([1988] BCLC 282) to the effect that a contingent creditor has *locus standi* to present a petition on the just and equitable ground. Whether the petition would succeed or constitute an abuse of process of the court would depend on the underlying facts. Having considered the factual position of *Stewardship*, the judge held that “the substratum of the company has gone.” The judge appeared to be particularly persuaded that this was the case given the magnitude of the requests for redemptions and also the magnitude of the fraud which had been perpetrated against the company in the US. While the judge held that “there is at least a good *prima facie* case for saying that a winding-up order would be made on just and equitable grounds” it is difficult to see how the judge’s findings on this point takes the matter beyond saying that *Stewardship* was insolvent. It is certainly arguable that the substratum of *Stewardship* was no more gone than in the case of any other insolvent company. The English authorities on this point suggest that the concept of the substratum of a company having disappeared turn on whether or not the objects for which the company was formed have disappeared or become impossible and that such a finding should turn on a consideration of the memorandum of association. It remains to be seen whether this finding turns on the facts of *Stewardship* or whether under Bermuda law “just and equitable winding-up” will be pursued more often on the hearing of winding-up petitions.

It is of particular note that the courts of

“There will be further contested winding-up petitions resulting from the current economic climate as well as subsequent contentious litigation by liquidators”

other off-shore jurisdictions have also, in the very recent past, had to grapple with some of the issues which arose in *Stewardship* in cases which also concern litigation proceedings commenced by redeeming shareholders. In December 2008 the High Court of the British Virgin Islands decided *SV Special Situations Fund Limited v Headstart Class F Holdings Limited* while the Court of Appeal in the Cayman Islands issued its decision *In the Matter of Strategic Turnaround Master Partnership Limited*. In the former case the British Virgin Islands court considered the status of a redeeming shareholder and held, having construed the statutory scheme set out in the Insolvency Act 2003, that it was a creditor for the purposes of presenting a winding-up petition. In the Cayman Islands decision the Court of Appeal there also considered the scope of “just and equitable winding-up.” On the issue of the status of a redeeming shareholder, it also held that the redeeming shareholder was a creditor given the terms of the company’s Articles of Association. However the Cayman Islands’ Court held that notwithstanding its creditor’s rights the redeeming shareholder remained a shareholder until it had received payment and its name had been removed from the register of members. It was thus bound by the operation of provisions in the company’s constitutional documents which allowed the fund to suspend redemption proceeds to the redeeming investors. This issue did not arise directly on the facts of *Stewardship*.

It seems very likely that in the coming year litigation in the field of insolvency will continue to be prominent in the Supreme Court of Bermuda. It seems likely that there will be further contested winding-up petitions resulting from the economic climate as well as subsequent contentious litigation by liquidators once they have undertaken the process of analyzing past transactions and directors’ conduct. In addition to contentious winding-up proceedings such as *Stewardship*, the Bermuda Courts continue to see a fair amount of non-contentious applications relating to insolvent liquidations and restructuring by way of schemes of arrangement. Often such Bermuda schemes of arrangement are part of more extensive cross-border restructuring schemes and the Bermuda courts have a strong record of cooperation with and facilitating such cross-border restructurings.