



# Judgments Cast New Light On Redemptions

## Decision could have adverse implications for funds of funds

JEREMY WALTON, PARTNER, APPLEBY

Questions surrounding the scope and extent of a fund's powers to gate or suspend redemptions have been among the most common posed to lawyers in the last 18 months, as funds have struggled to contain the outflow of assets sought by investors trying to escape the effects of the credit crunch.

The controversial questions had largely to be answered without the benefit of judicial guidance, since there has been very little litigation in the boom of the last decade. Even in the last 18 months, when fund managers have increasingly pushed the envelope in efforts to protect their funds from imploding, there was relatively little appetite for litigation; and such litigation as there was did not yield any significant judicial opinions or judgments which could guide the profession in advising fund clients.

Then, like London buses, three significant decisions came along at once. Within a space of three weeks, judgments were delivered by the British Virgin Islands High Court (In re SV Special Situations Fund) on 25 November 2008, the Bermuda Supreme Court (In re Stewardship Credit Arbitrage Fund) on 27 November, and the Cayman Islands Court of Appeal (In re Strategic Turnaround Master Partnership) on 12 December 2008.

### Strategic Turnaround decision

In *Strategic Turnaround Master Partnership*, the Cayman Islands Court of Appeal held that a general suspension of redemptions was effective to bind an investor who had put in a timely redemption request and whose redemption date had passed but had not yet been paid the redemption proceeds. As a result, the redeemer could not claim that it was owed a current debt and so had no standing to petition to wind up the fund on the ground of insolvency. The reasoning was that:

- The investor became a creditor for the redemption proceeds on the redemption date (in line with current thinking and recent jurisprudence) albeit those proceeds were yet to be quantified on that date.
- The investor nevertheless remained bound by the articles as a member after the redemption date and until his redemption was complete by removing his name from the register and paying his redemption proceeds.
- "Redemption" for this purpose meant the entire process, from the notice to redeem to the payment of proceeds.
- The offering memorandum of this fund specifically allowed suspension of the payment of redemption proceeds; although the articles did not, this was held not to change the analysis or the extent of directors' powers.
- This power could be exercised at any time before the redemption process was complete; in this regard,

the Court overruled the decision in the court below that the suspension was retrospective because it came after the redemption date, and there was no power to grant a retrospective suspension.

- The effect of this suspension was that the redeemer was merely a creditor with a future debt, rather than a current debt, and so had no locus to present a winding up petition.

However, it was also held that the investor would be allowed to amend and pursue its petition to wind up the fund on the 'just and equitable' ground, based on allegations that the power to suspend redemptions was improperly exercised and that the fund's conduct amounted to unfair oppression of the investor as a minority shareholder. This judgment has been hailed by some commentators as strongly supportive of the funds industry, and superficially this may be so. However, there are a number of substantive concerns that arise out of this judgment, which will remain to be addressed in future cases (or even in this one, whether on appeal from this judgment or at trial).

### Status of redeeming investors

First, it is difficult to reconcile the finding that a redeeming investor could be both shareholder and creditor, thus enjoying the rights of both. The court's decision was based on authorities from the 19th century, relating to entirely different types of entities (mutual benefit societies), and at a time when redeemable shares could not even be issued until permitted by amendment to the companies legislation.

In more modern times, with electronic registers for publicly-traded companies whose shares are bought and sold in fractions and on a daily basis, the hedge fund industry has come to a different way of thinking, encapsulated in the finding of the Bermuda Supreme Court in *Stewardship* (quoting from a New South Wales Supreme Court decision earlier this year, *Basis Capital Funds Management v BT Portfolio Services*):

"Once redemption has taken place, the position of the former unitholder is 'transmuted' from unitholder to creditor, if the redemption price is unpaid".

A similar conclusion was reached by the BVI High Court in *re SV Special Situations Fund*, where its company legislation specifically provides that "from the date of redemption, the former shareholder ranks as an unsecured creditor of the company for the sum payable upon redemption".

The judgment in *Strategic Turnaround* does not address how a fund's NAV is calculated when a redeeming investor is both shareholder and creditor. If the investor's shares remain in issue, at the same time as the redemption price becomes a liability of the fund, this will artificially depress the NAV of the

fund. The fund's auditors may similarly have difficulty in reconciling the balance sheet in its financial statements.

Surely the better analysis (even though leading to the same result) would have been to hold that the redeemer was no longer a member but still contractually bound by the investment contract documented in the subscription agreement, articles and offering document, which in turn make clear that no sum is due and owing to him (and so he cannot petition) until the date for payment of redemption proceeds has passed.

A corollary of the court's conclusion (although unaddressed in the judgment) appears to be that a redeeming investor in this position also enjoys other, unexpected and counterintuitive, shareholder rights. Thus, he could still participate or even convene shareholder meetings to restructure the fund's affairs (possibly to overturn the directors' decision to suspend redemptions); and could invoke statutory rights to seek the appointment of an inspector to investigate the fund's affairs including directors' decision (or other remedies to protect against minority shareholder oppression when the new Companies (Amendment) Law comes into force early in 2009). It may be that this aspect of the judgment will end up causing more problems for funds than was anticipated or intended.

### Inconsistent documentation

The *Strategic Turnaround* case was no exception to the common experience of inconsistent provisions in the constitutional documents of funds:

- The articles said only that the directors had an absolute discretion to suspend the determination of NAV and the issue and redemption of shares.
- The offering document said that the directors may suspend the determination of NAV or the issue or redemption of shares or the payment of redemption proceeds.

In the court below, the Chief Justice found these provisions to be inconsistent, and held that the more limited power in the articles should prevail. However, the Court of Appeal rejected that analysis and held that the provisions were consistent: the offering document merely "explains in detail how the powers in the articles may be used in practice". But in any event, since the court held that a power to suspend (of any kind) can be exercised at any time before the redemption process is completed by payment of redemption proceeds, the absence of an express power in the articles to suspend payments (as opposed to merely redemptions) did not actually matter. This conclusion will be surprising to funds lawyers who have been advising clients that in the event of an inconsistency between articles and

offering document, the former must prevail (absent an express provision to the contrary).

#### Redemption payment obligation

Finally, and perhaps most importantly, this judgment may encourage a fund with similar constitutional provisions to allow redeemers to go unpaid long after the usual time for payment has passed and, only when redeemers start to agitate (or sue) for payment, then simply suspend its payment obligation – apparently with contractual impunity.

Applying the court’s reasoning in Strategic Turnaround that a redeeming investor remains a member bound by the articles until payment, it would apparently make no difference to the result if a suspension took place before or after any due payment date had passed. On the facts of that case, the court considered a statement in the fund’s offering document that a redeeming investor “will receive at least 90% of the redemption price no later than 30 days following the date of redemption” was merely an indication and not a contractual promise in any event. However, no thought appears to have been given by the court to the following issues:

(a) Whether a fund has a contractual obligation to pay redemption proceeds at all.

It should be obvious that such an obligation exists: even where there is no express promise to pay proceeds within a particular time (as was held in Strategic Turnaround), there must at a minimum be an implied term that the fund will pay those proceeds within a reasonable time.

(b) Assuming that a reasonable time has elapsed, whether the fund can use the suspension power effectively to undo an extant breach of its contractual promise to pay and thus to eliminate the ensuing cause of action.

This issue was addressed in the Australian Basis Capital case. In that case, the court held that the fund was obliged to redeem a unitholder’s units and to pay the redemption price within a 30 day period specified in the fund’s constitution; it was not allowed to suspend redemptions after the 30 day period had passed: “It would not be fair to a member who has given due notice of a redemption request, to permit the manager to suspend redemption after the obligation to redeem had arisen and should have been performed. That would permit the manager to avoid the consequences of its own default”.

Similarly, in the Special Situations Fund judgment in the BVI, the court held (albeit in a different context concerning the timing of a decision to make redemptions in kind) that “the decision as to the manner of payment has to be taken when the

[redemption] notice is accepted and the date for satisfaction settled”. Again, this is consistent with the approach taken in Basis and Stewardship, but contrary to the approach taken in Strategic Turnaround.

#### Conclusion

As at the time of writing, an application for leave to appeal further has just been launched: this will surely pass muster as a matter of “particular public importance” so as to warrant leave to bring this case before the Privy Council.

While the decision may be thought by some to provide much-needed support to the hedge fund industry (at the expense of the investor community), such a view ignores the estimate that some 45% of hedge fund investors are in fact funds of funds, themselves mostly incorporated in the Cayman Islands: it is the fund of funds industry, already reeling from the worst year in its history, that stands to be most adversely impacted by this decision.

If the appeal fails and the Strategic Turnaround case goes on to trial, the petitioner will have to argue that, even if the funds could lawfully suspend redemptions long after the fact, such decisions were made for an ‘improper purpose’ and/or in breach of fiduciary duty, thus providing grounds for those funds to be wound up on a just and equitable basis. However, it is notoriously difficult to establish such claims, and in the current economic conditions one can hardly imagine the court criticizing a fund which seeks to exercise powers to staunch the haemorrhaging of assets which threaten its very existence.

It will also be interesting to see how the Grand Court, as Cayman’s court of first instance, approaches this judgment when faced with similar cases in the future: will it apply the principles broadly (as most commentators seem to assume) or will it seek to confine the Strategic Turnaround case to its own facts and rely on distinguishing features in other cases to come to a different conclusion? Certainly there will be ample opportunity to do so, by reference to the jurisprudence taken from other offshore jurisdictions which have taken a different approach to the promotion and protection of their funds industry. **THF**

#### BIOGRAPHY

##### JEREMY WALTON

Jeremy Walton is a partner in the litigation practice of offshore law firm Appleby and global head of the fund disputes team. Based in the Cayman Islands he also leads the commercial dispute resolution and insurance and reinsurance dispute resolution teams in Cayman.

---

“In the current economic conditions one can hardly imagine the court criticizing a fund which seeks to exercise powers to staunch the haemorrhaging of assets which threaten its very existence”

---