

Winding up a Cayman Islands Hedge Fund

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Hedge funds have long been the preferred investment vehicle for sophisticated private and institutional investors, and on the whole, those investments have proven to be prudent and profitable — in some cases, spectacularly so. However, nothing lasts forever.

With troubling economic times and the Cayman Islands being home to around 85 percent of the world's hedge funds, it is little wonder that this small Caribbean island is beginning to experience an exponential increase in fund liquidations at the instigation of disgruntled investors.

In an ideal world, investors might be expected to work in tandem with the directors to steady the ship via the investigation and implementation of the various available strategic and structural solutions. However, the reality is that in many cases, lurking just beneath the surface of a distressed hedge fund dwell unscrupulous investment managers, overinflated net asset values (NAVs), investors clambering over each other to redeem their investments, and funds adopting a siege mentality.

Given the usual multilayered structural complexities and cross-border issues that typify a Cayman Islands fund, any attempt to propound a one-size-fits-all approach is somewhat pointless. Nonetheless, general

principles and direction can be gleaned from legislation governing hedge fund liquidations, namely the Companies Law (CL), which received a significant overhaul in March 2009, and the Companies Winding Up Rules (CWUR), which were also revised during that overhaul.

Suspension of Redemptions

In times of distress, directors commonly have broad powers under a fund's articles of association to suspend redemptions, providing a temporary respite from the obligation to pay redemption requests and buying time to work on stabilizing the fund. Although a decision to suspend redemptions historically was seen as a death knell for a fund, in recent times much of this negative stigma has disappeared. Instead, investors are now beginning to view a suspension as the first step in hopefully rehabilitating a fund.

Difficulties arise, however, when directors use the suspension power to provide indefinite life support to a fund rather than as a window of opportunity to investigate and implement a possible cure. A suspension of redemptions was never intended to be a solution to the problems a fund may be experiencing — merely a tool to allow time for problems to be identified and addressed.

Some funds are now at the stage where long-term suspensions are in place, which results in external pressure from investors and internal pressure from corporate and legal advisors to either lift the suspension or liquidate the fund. If a suspension of redemptions does not result in a stabilization of the fund, there are effectively two options:

- If the fund is or is likely to become insolvent and the directors, in consultation with the investors, believe that a compromise or arrangement with its creditors is a viable alternative to winding up the fund, the fund may appoint a provisional liquidator to present the proposed scheme [CL Sec 104(3)].
- If there is little or no likelihood of recovery, then a petition can be presented to the Grand Court of the Cayman Islands to wind up the fund.

The Winding Up Application

The winding up of a Cayman Islands fund may be petitioned by the company, a creditor (including a contingent or prospective creditor), or a shareholder [CL Sec 94] on grounds that the fund is insolvent or it is just and equitable to wind up the fund [CL Sec 92]. If the petition is successful, an official liquidator, who must be a qualified insolvency practitioner, is appointed to wind up the affairs of the fund.

In the context of a winding up application presented following a suspension of redemptions, it is unlikely that an investor, even one who has a crystallized redemption entitlement, would have standing to present the petition. According to a recent decision of the Cayman Islands Court of Appeal, the redemption of shares is a process and not an event, and until the process is complete, an investor remains subject to the articles and therefore is bound by any lawful suspension.

Therefore, any winding up application issued by an investor would have to be in his capacity as a shareholder, unless he is a creditor of the fund independently of his shareholding. Any such

application would have to satisfy the court that the investor had a tangible interest in the outcome of any liquidation — that is, that there would be a surplus available for distribution to shareholders after creditors were paid.

The usual basis upon which an investor petitions the winding up of a fund is on the “just and equitable” ground that the fund is unable to achieve the purposes for which it was incorporated and its substratum has failed. A typical factual matrix underpinning a winding up on the just and equitable ground may be:

- a. The value of assets held by the fund has been decimated.
- b. Share redemption requests far exceed the value of fund assets.
- c. The fund is highly unlikely to receive any fresh injection of funds.
- d. Consequently, the fund is unable to carry on business as an investment vehicle for shareholders.

Shareholders’ Role in Liquidation

Upon the appointment of an official liquidator to a fund, unless the court otherwise directs, a liquidation committee is established [CWUR O.9 r.1(1)]. It is the duty of the official liquidator to report to the members of the liquidation committee all such matters as appear to him to be, or as the members have indicated to him as being of concern to them, with respect to the winding up [CWUR O.9 r.3(1)]. The role of the liquidation committee is effectively to oversee the actions of the official liquidator and provide input into important decisions he may wish to take.

For a shareholder to be eligible for appointment to the liquidation committee, there must first be a determination by the official liquidator that the fund is solvent or of doubtful solvency [CWUR O.9 r.1(3) & 1(6)]. The concept of “doubtful solvency” was first introduced to the Cayman Islands legislative regime earlier this year on March 1. Unlike “insolvency,” which is defined in the CL, there is no definition of “doubtful solvency.”

There has yet to be any judicial pronouncement in the Cayman Islands on what criteria must be met for a fund to be “doubtfully” solvent. Some direction may be gained, however, from the Australian position, where (albeit in a different context) the Supreme Court has held that for a company to have doubtful solvency, there must be a real, and not remote, risk of insolvency. The term “doubtful solvency” is used interchangeably with the phrase “would inevitably become insolvent.”

Applying a similar interpretation to the Cayman Islands legislation, CL s.93 provides that the solvency of a Cayman Islands company is determined by a cash-flow test (as opposed to a balance sheet test), and the issue to be considered is whether the company is able to pay its debts. A Cayman Islands company of doubtful solvency may therefore be one that has a real, and not remote, risk of being unable to pay its debts.

In the context of hedge fund liquidations, there are often contingent future sources of cash flow, such as potential damages or compensation claims against third parties which, if successful, would result in all creditors being paid out in full and investors receiving a dividend. In those cases, it may well be arguable that the fund is still doubtfully solvent.

Given the importance of the liquidation committee in hedge fund liquidations, particularly from an investor perspective, Cayman Islands insolvency practitioners await a decision from the Cayman Court.

Appointment of a Liquidator

Assuming an investor can establish the grounds to wind up a fund, the first issue to consider is whether an appointment of a provisional liquidator is available. In a practical sense, the role of a provisional liquidator is to “hold the ring” by taking possession of the fund’s assets and conducting preliminary investigations into the state of the fund. Whether the option of appointing a provisional liquidator is available depends on whether the investor can establish that [CL Sec 104(2)]:

- a. there is a prima facie case for making a winding up order; and
- b. the appointment of a provisional liquidator is necessary in order to —
 - i. prevent the dissipation or misuse of the company’s assets; or
 - ii. prevent the oppression of minority shareholders; or
 - iii. prevent mismanagement or misconduct on the part of the company’s directors.

Ordinarily, an investor will seek to rely upon (b)(i) and/or (b)(iii) to base a claim for appointment of a provisional liquidator.

Almost without exception, should a fund proceed from provisional liquidation into official liquidation, the provisional liquidator will be appointed as official liquidator.

Once appointed by the Cayman Court, an official liquidator’s function is to [CL Sec 110(1)]:

- a. collect, realize and distribute the assets of the fund to its creditors and, if there is a surplus, to the persons entitled to it; and
- b. report to the fund’s creditors and contributories upon the affairs of the fund and the manner in which it has been wound up.

One issue an official liquidator will be particularly mindful of in fulfilling his function is the possibility of clawing back pre-liquidation payments to augment the funds available for distribution to creditors and investors. In this respect, there are effectively two categories of payments.

Redemption Clawbacks. At the top of the official liquidator’s list of potential clawbacks will usually be pre-liquidation redemption payments made to shareholders. As a general rule, unless the articles provide otherwise, shares may not be redeemed from capital —only from profits of the fund or out of the proceeds of a fresh issue of shares made for the purposes of the redemption [CL Sec 37(3)(f)].

Even if the articles permit a redemption to be financed out of capital, a payment will not be lawful unless immediately following the date on which the payment is proposed to be made the fund is able to pay its debts as they fall due in the ordinary course of business [CL Sec 37(6)(a)].

With all pre-liquidation redemption payments, therefore, the official liquidator is required to investigate the terms of the articles of association and the solvency of the fund at the time of the payment. If all of the preconditions for validity are not met, then a redemption payment is unlawful and may be clawed back from the investor.

Further, even if a redemption payment complies with the requirements of the CL, it does not necessarily follow that the quantum will be accepted by the official liquidator. This is particularly topical given the large number of cases emerging in the Cayman Islands in which NAV calculations have been overstated — sometimes massively so — in the months leading up to liquidation. In such circumstances, the official liquidator may well be entitled to restate the inflated NAV determinations, recalculate the entitlements of redeemed shareholders, and claw back any overpayment made.

Occasionally, the articles of association of the fund will allow the fund to restate a NAV determination provided certain conditions are met (e.g., the presence of manifest error). If the circumstances fall within those conditions, all well and good. If not, the official liquidator will need to resort to common law principles.

The primary remedy allowing a fund to restate the NAV and claw back redemptions pursuant to the laws of the Cayman Islands is based on the common law principle of restitution on the ground that the payment was made under a mistake of fact. The official liquidator would argue that the redeemed investor had been unjustly enriched as a result of the overpayment, which was based on a mistake as to the amount of the payment. It is likely that such a claim would be strong, but subject always to the possible defense that the

redeemed shareholder had changed his position in good faith as a result of receiving the redemption money such that it would now be inequitable to require him to repay it to the fund.

There are as yet no reported Cayman Island cases concerning fund redemptions made in error. However, the common law principles of restitution are already enshrined in the laws of the Cayman Islands via numerous decisions of the Grand Court in other contexts. There is no reason to doubt that the same principles will be extended to apply to redemption payments made under a mistake of fact.

Avoidance of Preferences and Undervalue Transactions. The official liquidator will also consider whether there are any voidable preferences or undervalue transactions undertaken in the period leading up to the liquidation. A transaction:

- a. will constitute a preference and be voidable if it was undertaken within six months from the onset of insolvency of the fund with a view to preferring a creditor. In this respect it must be noted that in the case of related party transactions, a payment will be deemed to have been made with a view to preferring the related party. [CL Sec. 145]
- b. will be an undervalue transaction and voidable if it is undertaken within six months prior to the liquidator commencing proceedings to set aside the transaction, and the transaction was made with the intention of defrauding a creditor. [CL Sec. 146]

In addition to the application of the CL, it must be noted that the Cayman Islands Fraudulent Dispositions Law provides that every disposition of property made with an intent to defeat an obligation to a creditor, and at an undervalue, is voidable.

Other Actions

In addition to investigating the possibility of clawbacks for the benefit of the fund, the official liquidator will also consider whether any claims are available against parties related to the fund. The likely targets for such

claims are the investment manager and directors of the fund and, in some cases, the auditor and even the administrator.

To assist with his investigations, the official liquidator has broad powers, including the right to apply to the court for an order allowing the examination of or delivery up of documents by a director of the fund, a service provider to the fund, or any other person who is or has taken a role or been concerned in the management or promotion of the fund [CL Sec 103(3)].

Claims available to the official liquidator may include:

- a. Breach of contract against the investment manager for undertaking investments outside of the mandated strategy for the fund.
- b. Restitution from the investment manager for overpayment of management fees calculated by reference to an overstated value of fund assets.
- c. Breach of fiduciary duties against the directors for failing to exercise due diligence in ensuring that the fund operated in accordance with the offering memorandum.

It must be emphasized that these are claims available to the official liquidator because the loss was suffered by the fund. Any consequential loss suffered by individual investors will be merely “reflective” of the primary loss suffered by the fund.

That is not to say that investors cannot commence a private action, such as a misrepresentation claim against the directors and/or the investment manager, for inducing investors to invest in the fund when the offering memorandum was materially false or misleading. This is but one example of an investor claim and, depending on the facts of the individual case, there may be others.

Final Distribution to Investors

Once the official liquidator has maximized the returns to the fund through clawbacks and damages claims against third parties, a distribution must be effected in accordance with the priority prescribed in the

Companies Law. It is critical here for an investor to note that the status of a redeeming shareholder is effectively that of a second-class unsecured creditor. That is, redemption payments rank in priority after all other debts and liabilities of the company, but before any amounts due to members in satisfaction of their rights as members [CL Sec 37(7)].

Workable Regime

Although this article has barely scratched the surface of the various claims and issues that may arise in the context of the winding up of a Cayman Islands hedge fund, it is clear that the Companies Law, and particularly the amendments to the legislation introduced in March, provide a sensible and workable regime within which fund liquidations will be undertaken. As the body of local caselaw grows, it is expected that further efficiencies will be driven into the liquidation process.

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