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www.hflawreport.com Volume 4, Number 3 January 21, 2011

Redemptions

Strategic Turnaround Judgment Provides Welcome Guidance for the Hedge Fund Industry on the Suspension of Redemptions

By Jeremy Walton, *Appleby*

Among the most debated issues in the funds industry over the last two years are the questions to what extent, and when, can a fund suspend redemptions, and what is the effect on a redeeming investor of a suspension imposed by the fund after the investor's redemption notice has expired?

The recent judgment of the Judicial Committee of the Privy Council in *Culross Global SPC Limited v Strategic Turnaround Master Partnership Limited* provides helpful and authoritative guidance about how provisions in a fund's contractual documentation addressing redemptions and suspensions of redemptions should be interpreted, and how to determine which of the various documents constituting the investment agreement between a fund and its investor should take priority if the documents contain inconsistent provisions.

The Privy Council held that a fund did not have power to suspend the payment of redemption proceeds after a valid redemption notice submitted by the investor had expired, having construed the fund's articles of association and other contractual documentation. As a result, the investor was held to be a creditor of the fund following the expiry of its redemption notice and thus had standing to petition to wind up the fund for non-payment of its redemption proceeds.

The judgment was delivered on an appeal from the Cayman Islands Court of Appeal in respect of a Cayman-incorporated fund, but it will be of interest to and relied upon in other jurisdictions with an offshore funds industry whose courts are facing similar litigation and particularly those whose appeal procedures also culminate in the Privy Council.

The Facts in Outline

Culross subscribed for shares in the fund between 2006 and 2007 for a total price of US$1.84 million. On October 31, 2007, it gave notice to redeem all its investment and a redemption date of March 31, 2008 (Redemption Date) was subsequently agreed. On April 11, 2008 the fund's administrator confirmed to Culross' custodian that the redemption was approved for March 31, 2008 and that 90 percent of the redemption proceeds would be paid within 30 days, with the balance to follow upon completion of the fund's annual audit.

After the expiry of the redemption notice on April 17, 2008, the fund's board decided to suspend all redemptions in light of volatility and illiquidity in the U.S. micro-cap turnaround sector, and on April 22, 2008, the fund made further resolutions, the effect of which was to suspend the calculation of net asset value (NAV) and the issue and redemption of shares. The fund also resolved that all notices of redemption which had already been received were to be suspended until the directors decided to lift the suspension, noting that those investors who had issued redemption notices could revoke them. These resolutions were purportedly made pursuant to powers set out in the articles of association of the fund.

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A NAV as of March 31, 2008 in respect of Culross' shares was calculated on April 30, 2008 and communicated to Culross on May 14, 2008. The fund failed to pay at least 90 percent of the redemption proceeds and Culross petitioned on June 10, 2008 for the fund to be wound up. The fund opposed the petition and sought to strike it out on the basis that Culross was not a creditor because the fund had no present obligation to pay it anything in light of the decision to suspend redemptions.

The Decisions Below

At first instance, the Chief Justice held that Culross was a creditor because the articles did not give the fund the power to suspend payments retrospectively in respect of redemptions where the redemption notice had already expired. The Court of Appeal allowed the fund's appeal and reversed the Chief Justice, holding that:

- Culross became a creditor for the redemption proceeds on the Redemption Date, even though those proceeds had not been quantified on that date.
- Culross nevertheless remained bound by the articles as a member after the Redemption Date and until the redemption was complete by removing its name from the register and paying the redemption proceeds.
- "Redemption" for this purpose meant the entire process, from the notice to redeem to the payment of proceeds.
- The offering memorandum of the fund specifically allowed (although the articles did not) suspension of the payment of redemption proceeds; the terms of the offering memorandum were held to prevail over the terms of the articles and so this gave the directors the power to suspend such payments.
- The power to suspend redemptions could be exercised at any time before the redemption process was complete (i.e., before the final payment had been made to Culross following the annual audit) and therefore the fund could suspend not only the payment but also the redemption itself.
- The effect of the suspension was that Culross was merely a creditor with a future debt, not a current debt, and so had no standing under the Companies Law to present a winding up petition (a decision which has since been effectively reversed by a subsequent revision to the Companies Law giving prospective and contingent creditors standing to present a winding up petition).

The Privy Council's Decision

The Privy Council approached the question as one of construction: the parties were free to agree how to regulate redemptions, and how they had chosen to do this depended on a detailed analysis of the contractual documentation. The Privy Council reasoned as follows:

- None of the Victorian cases on which the Court of Appeal had relied, when holding that a member does not cease to be a member of a company until such time as his name is removed from the register of members, were relevant to the present case; those old cases related to building societies where "there was a strong mutual element, reflected in the power of the members to change the rules from time to time. . . ."
- The offering memorandum did not purport to contain legal advice and in it prospective investors were exhorted to obtain their own advice on the offer; the offering memorandum also expressly stated that it did

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not purport to set out a complete description of the Memorandum or Articles of Association of the fund or any of the other relevant documentation pertaining to the fund.

- Section 37(3)(c) of the Companies Law provided that the terms on which shares are to be redeemed must be authorised by or pursuant to the articles of association; to the extent that certain articles referred to the offering memorandum, the terms of the latter were expressly relevant, but the offering memorandum itself made clear that the legal relationship between the fund and its shareholders was defined by the articles and not the offering memorandum.
- The Court of Appeal had treated the provisions of the offering memorandum as expressly incorporated in the articles, and had wrongly interpreted the articles of association in the light of the terms of the offering memorandum.
- The focus of provisions in the articles concerning redemptions was on the Redemption Date by reference to which the redemption price crystallized: the payment obligation was dealt with as a matter subsidiary to the ascertainment of the redemption price. While both stages may be said to be part of a continuing process, it did not follow that "redemption" only occurred at the conclusion of that whole process.
- The existence and extent of any power to suspend the payment of redemption proceeds after the Redemption Date is a subject on which a fund and investors were at liberty to make any contract between themselves which they pleased. However, this would require clear words to that effect in the articles (and those in the instant case read naturally to the opposite effect).
- There should be no a priori view that, until the payment of redemption proceeds an investor should necessarily remain a shareholder of the fund; and the fact that an investor's name remains on a register of shareholders does not mean that it should have done so under the fund's articles.
- The provisions of this fund's articles dealing with suspension of redemptions were not, on their true construction, intended to operate on redemption notices which had already expired (i.e., where the Redemption Date has passed) as at the date of the suspension. The terms of the articles and the offering memorandum were not consistent, but in this case the former prevailed over the latter (contrary to the view expressed by the Court of Appeal).

The Privy Council was fortified in its conclusion by reference to commercial sense. The fund was an investment vehicle to which investors could, for a defined period, commit funds and which offered investors, for obvious commercial reasons, the relative security of a defined route by reference to which they might recover the value of their investments at a defined date. The fund's analysis was unattractive for investors in the fund and by extension for the fund itself as an institution seeking investors in subjecting them to different and much greater insecurity.

Accordingly, Culross's appeal was allowed and it is therefore entitled to prosecute its case on the basis that it was, as at June 10, 2008, a creditor of the fund.

Helpful Guidance for the Hedge Fund Industry

The Privy Council's decision is a welcome decision for funds practitioners and an authoritative development of jurisprudence in this field. Points of general application,

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which are expressed in or are implicit in the judgment, include:

1. Disputes of this kind are to be resolved almost wholly by reference to the documents constituting the contractual relationship between the parties. The Court will apply a commercial approach to the interpretation of those documents to ensure that the effect of the documents properly reflects what the parties (acting reasonably) intended.
2. Fund documentation may provide for the retrospective suspension of redemptions: such provisions are not contrary to principle. If the contractual documents do properly provide by clear language for such retrospective suspension then this should be enforced by the court. Whether such provisions should be included in a fund's articles is a commercial, and not a legal, consideration.
3. A commercial construction of a fund's constitutional documents will normally require its articles of association to take precedence over the terms of the offering memorandum, but this is a matter where the parties are free to regulate their relationship: a fund can determine which provisions of which documents will take precedence in any given situation, as long as this is clearly drafted. However, non-contractual provisions in an offering memorandum can still give rise to misrepresentation claims by investors who relied on them in deciding to invest.
4. Redemption is not a process but an event, the contractual documents determining when that event comes about.
5. If an investor has effectively redeemed in accordance with the constitutional documents of the fund, that investor is a creditor of the fund with standing to petition to wind up the fund.

Unresolved Issues

While the judgment provides welcome clarification on some issues, others have been left open, at least two of which were canvassed (albeit only faintly) on the appeal.

In particular, the Privy Council did not take its opportunity to address in any detail the views expressed by first instance courts in Bermuda (*BNY AIS Nominees v Stewardship Credit Arbitrage Fund, In re New Stream Capital Fund*) and in the British Virgin Islands (*In re Livingston International Fund, SV Special Situations Fund v Headstart Class F Holdings, Western Union v Reserve International Liquidity Fund*) that once a redemption date has passed, a shareholder is automatically "transmuted" into a creditor. The judgment of the Board merely noted that:

> These decisions all turn on the particular statutory and contractual provisions in question in them, and they are as stated first instance decisions. They do no more than lend some comfort that the view which the Board takes of the present contractual scheme is unlikely to be regarded as unusual or surprising.

In many fund disputes, both first instance and appellate courts have been wary of laying down binding precedent, seeking to restrict their decisions to the particular facts and documents of their cases. It was therefore predictable that the Privy Council might take this line in rejecting an invitation to harmonize the jurisprudence of a number of offshore jurisdictions for whom it provides the final court of appeal. It may well be that the Privy Council was simply anticipating the possibility of an appeal from one of the Bermuda or BVI cases coming before it in due course, and did not want to say anything now which might later be thought to influence how that appeal should be determined.

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However, it is slightly unsatisfactory that the judgment contains no clear statement about whether or not (at least as a matter of Cayman law) a redeeming investor may be classified as both a shareholder and a creditor pending receipt of its redemption proceeds. It is implicit from the judgment that a fund's contractual documentation may specify that an investor remains a shareholder and thus enjoys rights qua shareholder until it has been redeemed in full, although absent clear wording in a future case the contrary will doubtless be argued.

The Privy Council could legitimately have explored some legal and practical consequences of the proposition that a redeeming investor has the status of shareholder as well as creditor, although it appears from the judgment that the parties had not put forward the necessary material with which to do so.

The "transmutation" analysis advocated by the Bermuda and BVI courts has not only the advantage of simplicity, but also avoids potential difficulties for a fund in how it treats a redeemed but unpaid investor in its accounts, i.e., as shareholder (capital) or as creditor (liability). This accounting point was advanced on the appeal but was not fully argued, and the Privy Council declined to decide it; the Privy Council did note, however, that the fund's counsel was not able to advance a satisfactory response to the argument. The inference to be drawn from its contractual analysis is that this accounting question will be determined by the terms of the agreement as to redemptions.

Potentially a Pyrrhic Victory for the Investor

This is not the last word for the *Strategic Turnaround* litigation; this was an appeal on a preliminary question. The case now returns to the Grand Court of the Cayman Islands for trial. At that trial, further outstanding issues will be decided, including whether the fund is actually insolvent and whether the Court should nevertheless wind up the fund under the just and equitable ground (a further ground added to the petition with the permission of the Court of Appeal).

A further point not resolved on this appeal, but touched on in the judgment, is the question of a fund's insolvency and its effect on the investor's position as a creditor of the fund. If there is a suspension of redemptions, such is quite likely to constitute evidence that the fund is not able to pay its debts as they fall due; and there is only a cashflow test for insolvency under Cayman law. A successful petition on the basis that the fund is insolvent for non-payment of redemption proceeds is likely to be a Pyrrhic victory because of the effect of sections 37(6) and 37(7)(a)(ii) of the Companies Law: an unsatisfied redemption notice can be enforced against a liquidator only if, in the period between the redemption date and the winding up date, a fund was able to pay its debts as they fell due. In such case (especially if the fund made a payment out of its capital in order to redeem the shares), a liquidator might well reject the investor's proof of debt in the liquidation, effectively depositing the investor back in the pool with other shareholders who had not redeemed and who rank behind all creditor claims.

In the period between the Court of Appeal and Privy Council judgments in the *Strategic Turnaround* case, the Grand Court of the Cayman Islands heard another winding up petition brought by a fund investor whose redemption had gone unpaid (*Re Matador Investments Limited*). The Court in that case declined the fund's invitation to determine the effect

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of these provisions on the petitioner's claim: it held that the petitioner had done enough to show that it had locus standi and was prima facie entitled to a winding up order, while the adjudication of its claim was a matter for the liquidators following their appointment.

The ironic result is that a party who successfully petitioned as a creditor may nevertheless not reap any rewards from that success. It remains to be seen, when the *Strategic Turnaround* case returns to the Grand Court for trial, whether the petitioning investor ends up suffering this fate.

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