



Comment on Stewardship Credit Arbitrage Fund Limited decision

A recent Bermuda Supreme Court decision relating to a petition to put a hedge fund into provisional liquidation makes certain findings in reference to redemptions in kind which will be of interest to all lawyers advising investment managers and/or funds. In addition, the case is the first Bermuda case which makes a finding on the status of investors which have redeemed from funds but not been paid, and also gives some useful guidance on the question of restating NAVs in cases of fraud.

Redemption in kind

The fund tendered a payment in kind to a redeeming investor in the form of participation notes. The features of the participation notes were such that they were to evidence beneficial ownership interests in a trust created by the fund for the purpose of pooling loans subject to the participation. The notes were not transferable, provided for payment to the holder upon receipt by the fund of any payment of principal or interest on the underlying loans, and purported to be certificates.

The bye-laws of the fund allowed for redemptions in kind and required that the assets distributed have a value equal to the relevant Redemption Price.

An investor which received such participation notes petitioned to wind up the fund on the grounds that the fund had not satisfied its redemption obligations, the investor had not received assets valued at the Redemption Price and thus was an unpaid creditor of the fund.

The Judge concluded, firstly, that it was doubtful that the participation notes could properly be described as assets of the fund. He accepted counsel's argument that the trust arrangements which were an integral part of the participation notes meant that the fund continued to hold the assets in question in trust for the redeemed investor. The Judge held "it seems to me in these circumstances highly doubtful that the arrangement envisaged under the Participation Notes could properly be described as a distribution".

This eAlert is published by APPLEBY and is not intended to be, nor should it be used as, a substitute for specific legal advice on any particular transaction or set of circumstances. It does not purport to be comprehensive or to render legal advice and is only intended to provide general information for the clients and professional contacts of Appleby as at the date hereof.

Secondly, he found there was no value in the participation notes as notwithstanding the notes were not transferable or negotiable there “was only an expectation in due course, payments would be made under the underlying note to the fund, which the fund (as trustee) would then have an obligation to pass on to the respective noteholders. The notes were no more than derivative instruments created by [the fund]. Even if it could be said that the Participation Notes did indeed constitute assets of [the fund], it cannot possibly be maintained that the notes have a value equal to the relevant Redemption Price”.

The conclusion, therefore, was that the tender of the participation notes did not constitute a payment in kind and did not constitute satisfaction of the fund’s obligation pursuant to the investor’s redemption.

Position of the Redeeming Investor

The Judge was also called upon to consider whether, following redemption and the striking of the Redemption Price, the investor was a creditor. The Judge found that the failure of the fund to discharge its redemption obligations put the investor in the position of a creditor: he said 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 the absence of any local authority, the Judge followed a recent Australian authority, *Basis Capital Funds Management Ltd v BT Portfolio Services Ltd* [2008] NSWSC 766, in which it was held that “once redemption has taken place, the position of the former unitholder is ‘transmuted’ from unitholder to creditor, if the redemption price is unpaid”.^[1]

Restatement of NAV

The fund had been a victim of the Petters Group fraud and certain of the loans which were the subject of the participation notes included loans connected to this fraud which were unlikely to be recoverable. This raised a question whether the fund’s NAV at the Redemption Date for this investor should be restated. The Judge held that there was no case to restate 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 the fund’s ignorance (at that time) of the fraud was not the effective cause of making a payment based on an incorrect NAV.

Comment

This judgment very much turned on its facts and its bye-laws, and it was also an interlocutory judgment for the purposes of determining whether the fund should have provisional liquidators appointed. The test for appointment of provisional liquidators is merely whether the petitioner has made out a good prima facie case that a winding up order will be made, and, if that hurdle is cleared, whether it is right that they should be appointed.

[1] It should, however, be noted that an even more recent decision by the Court of Appeal in the Cayman Islands (*In the matter of Strategic Turnaround Master Partnership Ltd, delivered on 12 December 2008*) held that such an investor, notwithstanding his creditor rights, nevertheless remained a shareholder until it had received payment and its name had been removed from the register of members – and thus bound by the operation of provisions in a fund’s constitutional documents which allowed the fund to suspend redemptions and the payment of redemption proceeds to the redeeming investor. The Court in Stewardship did not have to consider the issue of suspending redemptions.

For further information, please contact:



Jeremy Walton
Cayman Islands
Group Team Leader
Fund Disputes
Tel: +1 345 814 2013
Email: jwalton@applebyglobal.com



Kiernan J Bell
Bermuda
Local Team Leader
Fund Disputes
Tel: +1 441 298 3205
Email: kbell@applebyglobal.com

Global Funds Contacts

Eliot Simpson	Local Team Leader	BVI	+1 284 852 5321	esimpson@applebyglobal.com
Frances Woo	Local Team Leader	Hong Kong	+852 2905 5720	fwoo@applebyglobal.com
Fraser Robertson	Local Team Leader	Jersey	+44 (0)1534 818 032	fr Robertson@applebyglobal.com
Rory Todd	Local Team Leader	London	+44 (0)20 7469 0522	rtodd@applebyglobal.com

Offices



Bermuda

Canon's Court
22 Victoria Street
PO Box HM 1179
Hamilton HM EX
Bermuda

Tel +1 441 295 2244
Fax +1 441 292 8666

Jersey

PO Box 207
13-14 Esplanade
St Helier
Jersey JE1 1BD
Channel Islands
Tel +44 (0)1534 888 777
Fax +44 (0)1534 888 778

British Virgin Islands

No 56 Admin Drive
Wickhams Cay 1
PO Box 3190
Road Town
Tortola VG 1110
British Virgin Islands

Tel +1 284 494 4742
Fax +1 284 494 7279

London

2nd Floor
2 Royal Exchange Bldgs
London EC3V 3LF
United Kingdom
Tel +44 (0)20 7283 6061
Fax +44 (0)20 7469 0540

Cayman Islands

Clifton House
75 Fort Street
PO Box 190
Grand Cayman KY1-1104
Cayman Islands

Tel +1 345 949 4900
Fax +1 345 949 4901

Mauritius

8th Floor
Medine Mews
La Chaussée
Port Louis
Mauritius
Tel +230 203 4300
Fax +230 210 8792

Hong Kong

8th Floor
Bank of America Tower
12 Harcourt Road
Central
Hong Kong

Tel +852 2523 8123
Fax +852 2524 5548

Zurich

Bahnhofstrasse 52
CH-8001
Zurich
Switzerland
Tel: +41 44 214 6525
Fax: +41 44 214 6524