

Shifting sands

British Virgin Islands lawyers are advising investors on dealing with distressed funds but fund formation work is starting to pick up.

The British Virgin Islands' rapid ascent as an international financial centre and hedge fund domicile has attracted a number of internationally recognised law firms to the jurisdiction.

The legal sector in the jurisdiction is robust, with the likes of Appleby, Conyers Dill & Pearman, Maples and Calder, Ogier and Walkers competing for business alongside BVI stalwart Harneys.

The financial crisis led to a slowdown in the fund formation work that is the backbone of many offshore legal practices. BVI firms report strong activity with restructuring and distressed funds work keeping them busy over the past three years.

"Distressed funds work was the dominant theme in 2009," says Ross Munro, a partner at Harneys. This primarily involved advising hedge fund managers on imposing gates or suspending redemptions, provided such actions were authorised by their governing documents.

There was also ample demand for legal advice on creating side pockets for illiquid assets and other means of avoiding liquidations at fire sale prices.

Credit Suisse Tremont estimates investors were unable to access \$174 billion in hedge fund investments at the end of 2008 due to suspensions, gates or side pockets. By the end of June 2010 around \$118 billion of this had been repaid to investors while \$56 billion remains inaccessible.

BVI lawyers are starting to receive enquiries from investors about possible remedies against funds that remain suspended. "Investors have had enough of



waiting. There may be a wave of litigation involving suspended funds later this year," says Robert Foote, a managing associate in the BVI office of Ogier.

The governing documents of a standard hedge fund will grant its directors the power to suspend redemptions in an emergency or crisis. However, the documents are usually silent on when the suspension ought to be lifted. It falls to the directors to assess the situation and lift the suspension if it is no longer in the best interests of the fund or its investors.

Investors may try to wrest control of the decision if they feel the directors are not acting in their best interests. This can be done by replacing the directors or by applying to the BVI courts to liquidate the fund under the BVI Insolvency Act of 2003.

"The Insolvency Act provides a robust framework for the liquidation of BVI companies. It is an effective piece of legislation which provides certain protections and remedies for investors," says Munro.

Investors can apply to the court to liquidate a fund on the grounds that it is insolvent or that it is just and equitable for it to be wound up. It is also possible to ask the court to liquidate a fund on public interest grounds.

The remedies for an investor will depend

on whether they are deemed to be a shareholder or creditor for the purposes of the Insolvency Act.

The BVI courts have considered the issue of when a shareholder becomes a creditor in a series of cases, including *SV Special Situations Fund v Headstart* (2008), *Citico Global v Y2K Finance* (2009) and *Western Reserve International v Reserve International Liquidity Fund* (2010).

The general consensus is that shareholders who submit a redemption request become creditors if they are not paid in full on the relevant dealing day. If the fund suspends redemptions, then it must still satisfy all redemption requests made before the suspension was in place on the next dealing day.

"We have seen funds get into trouble because they failed to properly suspend the NAV and redemptions prior to the dealing day. There have also been problems with funds that did not have adequate or workable mechanisms for gates or suspensions," says Robert Briant, a partner in the BVI office of Conyers Dill & Pearman.

Investors that become creditors can issue a statutory demand for the redemption proceeds if they are not paid on the dealing day. The fund has 21 days to respond. If the fund fails to meet this deadline, the creditor can



apply to the court to appoint a liquidator on the grounds of insolvency.

On the other hand shareholders can apply to appoint a liquidator on a just and equitable basis or due to *prima facie* insolvency. "If a fund is suspended and there is no hope of the suspension being lifted, then an investor may be able to convince the court that it is just and equitable to appoint a liquidator," says Julie Engwirda, an associate in the BVI office of the law firm Walkers. However, it is rare for a shareholder to succeed in such an action.

Investors should think carefully before moving to appoint a liquidator. "It is never an easy decision to ask the court to put a fund into liquidation," says Marco Martins, a partner at Harneys. "There is an element of suing yourself. The fund's resources are diverted to fighting the application. It becomes a lose/lose situation for investors," he says.

The courts can also be hesitant to order the liquidation of a fund. "The Cayman courts have ruled that the appointment of a liquidator should be considered a last resort. The BVI courts are yet to adjudicate on this issue," adds Foote at Ogier.

His advice to funds that continue to face liquidity problems is to maintain frequent communication with investors. "The manager can usually ward off legal action by keeping the investors fully updated on the liquidity of the assets in the fund and the outlook for returning cash," says Foote.

"So far we have not seen many investors bringing legal claims against funds that have suspended redemptions or imposed gates," says Munro at Harneys.

"In most cases, those provisions have been lifted and cash has been returned to those investors that wanted to redeem. However, funds are still suspended and investors are now starting to take legal advice on their options for reclaiming cash," adds Munro.

In most cases investors ask the courts to appoint a liquidator if their relationship with the manager has completely broken down, says Munro.

Liquidators are appointed by the court and can be BVI licensed insolvency practitioners or foreign liquidators. Once appointed, the liquidator takes custody of the fund's assets and aims to realise their value for the benefit of creditors.

The liquidation process itself can vary greatly depending on the assets of the fund and its structure. In some cases it can take years for the assets to be sold. The liquidator will often retain the services of the fund manager until the liquidation process is complete.

The BVI courts also have wide discretionary powers to order alternative remedies. "The court may, for instance, order the fund to buy out a disgruntled investor as an alternative to liquidation," says Walkers' Engwirda.

To date the bulk of liquidations in the BVI have been voluntary winding-ups. Lawyers are starting to receive calls from investors about forcing suspended funds into liquidation but few expect to see a wave of litigation. "It is expensive to take these cases to court. Ultimately, a lot of these claims will be settled out of court," says Foote.

More recently lawyers have noticed a change in the type of work coming their way. "There are signs of a recovery in the hedge fund industry," says Valerie Georges-Thomas, a partner in the BVI office of law firm Appleby.

Appleby has seen "fewer distressed funds over the past 12 months," says Georges-Thomas. "We are still dealing with a few solvent liquidations, but there is an encouraging increase in the number of enquiries about fund launches," she says.

"Restructurings and liquidations have subsided. We have done more fund formation work since the start of the year. Some of our bigger clients have launched new products," confirms Richard May, a partner in the BVI office of the law firm Walkers.

"We are seeing existing clients launching new fund structures," says Briant at Conyers. "We are also seeing a lot of work being driven by large institutional investors that have pushed for single investor funds," he adds.

Single investor funds and managed accounts were in high demand for a lot of 2009, says Harneys' Munro. "Large investors have become more sophisticated. They are not always happy to be commingled with smaller investors in a traditional fund structure," he says.

Harneys was instructed by a fund of funds to establish 'funds of one' for certain investors, adds Munro. "That works well in the BVI where fund formation is quick and cheap. The demand for these structures has dipped a little in 2010," he says.

Fund launches in 2010 have been primarily driven by existing managers establishing new products, confirms Simon Schilder, a partner at the law firm Ogier. "It is still very difficult for new managers. The start-ups that we see are launching with \$10-20 million in assets, mainly from friends and family," he says.

Ogier has seen an increase in fund launches out of the US and UK. The continental European market remains "very slow," says Schilder.

He has also noted the demand for single investor funds and managed accounts. "Investors are succeeding in negotiating bespoke terms or structures," says Schilder.

Harneys is seeing the greatest impetus in emerging markets. "There are two main streams of business from emerging markets," says Martins, who heads the Latin American practice at Harneys.

"We are seeing managers from Asia and Latin America establishing offshore structures for international investors. Fund managers in these regions are also looking to diversify their strategies by investing in international markets. This is generally done through an offshore vehicle in Cayman or the BVI," he explains.

Harneys opened an office in Hong Kong in 2007 which has helped the firm to win business from Chinese companies. "The BVI is the first choice in China for company formations. We expect to see more funds business from China as the local asset management industry continues to evolve," says Munro.

Lawyers are heeding the lessons learned in 2008 when drafting fund documents but there have been no wholesale changes in the terms being offered to investors.

"We have updated our documents based on court decisions and experiences over the past few years. One important change has been in defining when investors cease being shareholders and become creditors," says Catherine Ross, a partner in the BVI office of Walkers.

Lawyers are also paying closer attention to the terms that allow funds to suspend redemptions or make payments in kind. "We are making sure the terms that deal with suspending redemptions or creating sidepockets are watertight and give directors enough room to manoeuvre in a crisis," says Georges-Thomas.

There is more focus on fund terms, confirms Anton Goldstein, an associate in the BVI office of Conyers Dill & Pearman. "Investors are pushing funds to provide more information on their investments, including details of portfolio holdings. It is also more common for investors to negotiate special fee arrangements," he says.

The legal world is more prone to evolution than revolution and this is the case with respect to hedge fund documents. "The basic principles of drafting fund documents remain unchanged," says Kieran Walsh, a partner in the BVI office of law firm Maples and Calder.

"The focus since the financial crisis has been tightening up fund terms and ironing out any discrepancies between different documents, such as the articles of association and offering documents," Walsh adds. ■