OFFSHORE FUND DISPUTES

Review of 2018
In the Courts

February 2019

APPLEBY

REVIEW OF 2018

Funds were very much in view in the offshore courts during 2018 with the high profile liquidations of Abraaj and Platinum Partners in the Cayman Islands. The offshore courts have also given judgments addressing issues that are relevant throughout a fund's life cycle including indemnities and redemption notices, and – as set out here in our review of the year – there are important lessons which market participants can take from the cases to manage their own legal risk.

Appleby's review of offshore court cases across all other subject areas can be found in our annual publication 'In The Courts'.

LITIGATION OF FUND DOCUMENTS

Investment Authority

In Al Sadik[1], the Privy Council considered an appeal from the Cayman courts relating to the scope of an investment authority power. Mr Al Sadik invested over US$100m with Investcorp by acquiring shares in an investment vehicle pursuant to a share purchase agreement (SPA). Under Investcorp's direction, the investment vehicle followed a leveraged strategy, transferring funds to an SPV which borrowed heavily and then invested in hedge funds. As a result of the financial crisis, Mr Al Sadik lost more than 40% of his investment.

Prior to entering into the SPA, Investcorp had provided Mr Al Sadik with an investment proposal which referred to leveraged investments. The terms of the SPA contained a very broad general investment authority clause entitling Investcorp to take *"any actions that the board believes are necessary or desirable in order to effectuate the purposes of this investment."* However, the SPA contained no reference to leveraged investments and its only reference to borrowing powers was in the context of managing liquidity issues. On this basis, Mr Al Sadik brought a claim against Investcorp. The key issue considered by the Privy Council was whether Investcorp had authority to borrow money to leverage the investment. Mr Al Sadik argued that the express reference in the SPA to borrowing for liquidity purposes should be used to narrow the interpretation of the investment authority so as to exclude borrowing to leverage investments. The Privy Council rejected this argument and instead followed a literal interpretation of the general investment authority clause.

Given the widespread use of broadly drafted general investment authority clauses in investment management agreements, the Privy Council decision will be welcomed by market participants. Nevertheless, the decision is a reminder that market participants should ensure that the terms of investment management agreements are in line with the parties' intentions and understood by both manager and investor particularly where there are broad discretions as to strategy or the use of wide ranging investment (as opposed to merely risk management) tools such as leverage, hedging or other financial derivative instruments.

Privy Council followed broad literal interpretation of authority clause. Market participants should confirm authority clauses are:

- In line with parties' intentions
- Understood by both manager and investor

1 Al Sadik v Investcorp Bank BSC & Ors [2018] UKPC 15

Redemption Notices

In Ardon Maroon,[2] the Cayman courts considered automatic redemptions as part of a master-feeder structure. The feeder fund and the master fund had the same directors, investment manager, administrator and transfer agent. An investor submitted a redemption notice to the feeder fund which looked to the master fund to make good the redemption. However, the feeder fund did not submit a matching redemption notice to the master fund. The funds subsequently entered voluntary liquidation. The liquidators of the master fund rejected the feeder fund's proof of debt on the basis that there had been no separate redemption notice to the master fund. The court, therefore, considered whether the fund's constitutional documents provided for an automatic back-to-back redemption notice to be deemed at the master level where a redemption notice was given to the feeder fund. The court heard expert evidence that such automatic back-to-back redemptions are near universal market practice as they are necessary to avoid a mismatch between liquidity profiles. Nevertheless, the court followed a strict literal interpretation of the private placement memorandum and Articles and found that separate redemption notices were required.

The Cayman courts consistently adopted a strict literal interpretation of the construction of funds' constitutional documents in recent years. This case demonstrates that the Cayman courts are prepared to follow this approach even where that strict interpretation gives rise to a result which is contrary to market practice. The case is under appeal and the decision itself may change. However, irrespective of the outcome of the appeal, the strict interpretation of constitutional documents approach is well established in the Cayman courts. Market participants should note that the approach creates legal risk wherever there is a mismatch between a fund's constitutional documents and its operation. The linked article highlights six steps that market participants can take to manage that legal risk.

Literal interpretation of constitutional documents followed even where contrary to market practice. Creates legal risk where mismatch between a fund's constitutional documents and its operation – Market participants should identify mismatches and take steps to manage the risk

2 In the matter of Ardon Maroon Asia Master Fund (in official liquidation) (Unreported, 17 July 2018)

Indemnities

The appropriate protection of market professionals through indemnities is an essential part of maintaining a high quality funds industry. Two cases involving indemnities before offshore courts have demonstrated the risks of not properly drafting and incorporating indemnity provisions.

In Goodman v Cummings[3], the Cayman courts considered the application of a director's indemnity provisions. A claim was brought personally against a former independent director of Tangerine Investment Management Limited alleging breach of fiduciary duties. It was argued that the indemnification provisions in Tangerine's articles did not apply as they were not expressly incorporated into a formal agreement with the former director and, in any event, the former director did not fall within the definition of an "indemnified person" as she was no longer a director. The court pointed to an email sent by the former director prior to appointment noting her understanding that she would be indemnified and found that the articles were incorporated into her contract. The court also found that the former director was an indemnified person notwithstanding that she was no longer a director. In this regard, the court stated that any other conclusion would be absurd and would damage the Cayman funds industry by making independent directors less willing to act. While the court was willing to incorporate the indemnity provisions, the case demonstrates that incorporation is a not a given and market participants should ensure that proper steps are taken to incorporate director indemnities.

In Fairfield Greenwich,[4] the BVI Court of Appeal dismissed an appeal relating to indemnity provisions contained in investment management agreements. An investment manager acted as manager for a number of BVI feeder funds that had gone into liquidation as part of the fallout from the Madoff Ponzi fraud. The investment management agreements provided that the manager would be indemnified by the funds for "*any and all claims, demands, liability or expenses for any loss suffered by the Funds.*" The manger claimed that the costs it had suffered defending claims against the funds fell within the indemnity. The BVI court found that they did not. The Court of Appeal referred to the English Supreme Court case of Rainy Sky SA v Kookmin Bank in noting that "*a commercial result can be rejected even if it does not rise to the level of being absurd – it needs only be displaced by a more commercially sensible result*," but on the facts found that the original decision was consistent with the language of the indemnity and, therefore, dismissed the appeal.

Proper indemnification, and reliance, language is, therefore, crucial. The scope of indemnities and the class of indemnified persons needs to be carefully considered as part of this. For example, appropriate third party reliance language should be included for certainty and clarity. It is worth noting that many fund managers are now insisting that independent directors carry their own directors and officers insurance and this is rapidly becoming market standard.

Cayman's Court's approach highlights the importance of appropriate indemnity protections for independent directors. Market participants should ensure that indemnity provisions are properly incorporated or that independent directors carry their own D&O insurance

3 Steven Goodman v. Dawn Cummings and DMS Governance Limited (Unreported, 13 September 2018)
4 Fairfield Greenwich Limited et al v Kenneth Krys et al (Claim No. BVIHCMAP2018/0018, 4 October 2018)

INSOLVENCY AND RESTRUCTURING

Official Liquidation

Following high-profile US grand jury and SEC indictments alleging a USD1 billion fraud relating to the New York Hedge fund, Platinum Partners Value Arbitrage Fund LP, a Cayman master fund and an affiliated feeder fund were placed into liquidation in Cayman.

The Cayman liquidators obtained Chapter 15 recognition of the Cayman proceedings in the US Bankruptcy Court. As part of the Chapter 15 case, the liquidators served subpoenas on the funds' former auditors, seeking production of their work papers. When the auditors refused, the liquidators filed a motion with the bankruptcy court to enforce the subpoena and compel the production of the work papers. The auditors asserted that their work papers were not discoverable under Cayman law and that international comity prevented the Cayman liquidators from using the discovery tools under Chapter 15 to circumvent limitations under Cayman law. The court determined that there was insufficient evidence to conclude that the work papers were not discoverable under Cayman law and, in any event, international comity did not require US courts to offer identical relief only a comparable result. The decision is under appeal, but demonstrates the willingness among US bankruptcy courts assist Cayman liquidators with discovery following Chapter 15 recognition.

Provisional Liquidation

Abraaj Holdings and Abraaj Investment Management, a Dubai head quartered private equity firm, filed for provisional liquidation in Cayman in June 2018 following concerns from limited partners about the misuse of investor funds.

The companies initially placed themselves into provisional liquidation to gain the space and protection for a planned restructuring. Despite challenges from some creditors, six months later the companies continue to be in provisional liquidation as attempts are made to sell assets and identify solutions. While the approach has inevitably led to frustration for some creditors, it demonstrates the flexible approach that the Cayman courts are prepared to adopt in provisional liquidations and highlights potential opportunities for funds to control the process by putting themselves into provisional liquidations.

Approach to high-profile Abraaj provisional liquidations demonstrates the flexibility of provisional liquidation in Cayman and highlights the opportunities for funds to control the process by putting themselves into provisional liquidation

Just and Equitable Winding Up

Where there has been some mismanagement or other failing with a fund (be it a company or limited partnership), it may be "just and equitable" for it to be wound up in a solvent liquidation and a petition can be sought on this basis. A just and equitable winding up petition can be a powerful tool for fund investors to protect their interests.

Categories of cases in which a winding up has been ordered on just and equitable ground include(non-exhaustively) where:

- the "substratum" of the company is gone i.e. it has become impractical, if not impossible, to carry on the company's business in accordance with the reasonable expectations of its participating shareholders;
- there is deadlock in management;
- there has been loss of confidence in management, due to a lack of probity in their conduct of the company's affairs;
- there is a need for investigation into the affairs of the company; or
- the company is a "quasi-partnership" and the petitioner's legitimate expectations have been breached.

In Re Torchlight Fund,[5] the Cayman court considered a just and equitable winding up petition of Torchlight, a Cayman exempted limited partnership, brought by a number of limited partners. The Court found that the failings of Torchlight's general partner were insufficient to justify winding up the partnership. Moreover, the Court found that the petition had been brought to enable the petitioners to "obtain accelerated liquidity" rather than for the stated grounds and this was, therefore, an abuse of the just and equitable jurisdiction. The judgment contains useful guidance on what will constitute good grounds for a just and equitable winding up and emphasises the importance of demonstrating that the winding up is made for a proper purpose.

In Sturgeon Central Asia Balanced Fund,[6] the Bermuda Court of Appeal considered a just and equitable winding up of Sturgeon, a Bermuda exempted company, brought by a number of shareholders. The petitioners argued that changes to the bye-laws by the management shareholder which excluded petitioning shareholders from voting to wind the fund up demonstrated a lack of probity and led to a justified loss of confidence in the management's conduct of the fund's affairs. At first instance, the Court found that there was no evidence of bad faith and dismissed the petition on this basis. The Court of Appeal referred to the observations of Lord Wilberforce in Ebrahimi v Westbourne Galleries Ltd [1973] AC 360 that "to confine the application of the just and equitable clauses to proved cases of mala fides would be to negative the generality of the words" and noted that the shareholder had been denied a fundemental right. Accordingly the court allowed the appeal holding that, while lack of probity would be a strong factor in favour of a just and equitable winding up, it was not a prerequisite.

Just and equitable winding up can be a powerful tool for fund investors to protect their interests. Bermuda Court confirmed that bad faith is not a requirement for a just and equitable winding up

5 In the Matter of Torchlight Fund LP (Unreported, 28 September 2018)
6 Capital Partners Securities Company Ltd v Sturgeon Central Asia Balanced Fund Ltd [2018] CA Bda 5 Civ

Closed End Funds

As fund managers seek returns in a competitive market, many have found themselves holding illiquid investments with return horizons that extend beyond the intended term of the relevant fund. As a result, managers have needed to find creative methods for holding those investments or to obtain investor approval to extend the life of the fund. The Jersey courts considered two cases which arose as a result of funds having assets and liabilities which went beyond their intended terms.

In LXB Retail Properties PLC,[7] the Jersey courts considered whether a proposed scheme of arrangement satisfied the requirements of Articles 125 and 127 of the Jersey company law and, therefore, engaged the powers contained in those provisions. The company was a listed closed ended investment fund which aimed to create a long lease retail investment portfolio of out of town sites. The fund had assets and liabilities that extended well beyond its intended term. Accordingly, a scheme was proposed whereby certain assets and associated long term liabilities would be transferred to a separate company enabling the remaining clean assets to be realised and returned to shareholders prior to the dissolution of the company.

The court first considered whether the scheme constituted an 'arrangement' within the meaning of Article 125. The court held that 'arrangement' was to be broadly construed and should include any scheme where there was 'give and take' in altering the rights between the company and its shareholders. The court went on to consider whether the scheme was a 'reconstruction' within the meaning of 127. Article 127 provides a court with the power to dissolve the company without winding it up and this was a necessary element of the proposed scheme. The court found that 'reconstruction' had a commercial rather than legal meaning and that it required the continuance of the company in some form. As part of the fund was to be transferred to another company, the court considered that the scheme was a reconstruction. Accordingly, the court found that it had the necessary powers to implement the scheme and ordered a meeting of the shareholders to vote on the same.

In Greater Europe Deep Value Fund II Limited,[8] the Jersey Courts considered the dissolution of a fund that had been would up under Article 155 of the Jersey company law. The fund was a closed end investment expert fund set up for the purpose of investing in Russia and the former Soviet Union. As the fund neared its wind down period, the investment manager advised that the illiquid real estate and private equity assets would realise considerably more value if sold as a going concern beyond the wind-down period. A dispute arose as to whether the wind down period should be extended or the company wound up. Ultimately the court ruled that it should be wound up under Article 155 of the Jersey company law.

Once the fund had been wound up, the liquidators applied to court for dissolution. Article 155 contains no express power for a court to dissolve a company wound up under it, nor is there any other provision of Jersey law containing such an express power. However, as dissolution is the logical end point of any winding up, the court interpreted Article 155 as including a power to order dissolution and ordered the dissolution on this basis. The court also referred to its inherent power being based on necessity to being an alternate power.

Jersey Court considers cases where illiquid investments have meant that closed ended funds have need to be extended beyond their intended terms

7 Representation of LXB Retail Properties PLC [2018] JRC 049
8 Representation of the Liquidators of Greater Europe Deep Value Fund II Limited [2018] JRC 051

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ABOUT US

Appleby's Fund Disputes team is an industry leader, being one of the few offshore firms to field a specialist team dealing with fund disputes, and having been involved in a number of high-profile proceedings. Our team of highly skilled and talented fund disputes lawyers have experience that covers all types of funds, including corporate funds, limited partnerships, unit trusts, regulated mutual funds, closed-ended funds and private equity funds. We act for a wide range of parties involved in fund-related matters, including office-holders, directors, auditors, investment managers, shareholders and creditors.

Appleby provides Fund Disputes services in Cayman Islands, Bermuda, British Virgin Islands, Isle of Man, Guernsey, Jersey and Mauritius. We can also call on our experienced Funds and Investment Services team to provide further technical advice.

We regularly provide advice and assistance regarding matters such as:

- Redemption issues
- Shareholders' rights
- Directors' liabilities
- Enforceability of side letters
- Disputes between service providers
- Valuation issues
- Fraud and mismanagement of fund assets
- Restructuring distressed funds
- Winding up and dissolution of insolvent funds

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