APPLEBY

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In the Courts 2015: Funds

Directors' Liability

Directors of Cayman Islands funds commonly enjoy the benefit of indemnities from the company, either under service agreements or under the company's articles of association. Within certain limits, such indemnities are allowed by Cayman law. Conduct amounting to fraud or 'wilful default' cannot however validly be indemnified, and most clauses incorporate express exclusions to that effect. In its long-awaited decision in *Weavering Macro Fixed Income Fund Limited (in liquidation) v. Peterson and Ekstrom* (CICA 10/2011, 12 February 2015, unreported), the Cayman Islands Court of Appeal revisited the question of what exactly is meant by wilful default. At first instance, the Grand Court had found the Fund's independent directors to be in 'wilful neglect and default' such that they were unable to rely on the exemption from liability contained in the fund's Articles of Association, on the basis that they had almost completely failed to perform any functions or attend any meetings. The CICA upheld the Grand Court's finding of negligence but held that wilful default had not been established on the facts of the case. Applying the test as set out in *Re City Equitable Fire Insurance* [1925] Ch 407 and adopted in the Cayman Islands in *Prospect Properties Limited (In Liquidation) v. McNeill* [1990-91] CILR 171 the CICA confirmed that wilful neglect or default requires positive evidence of a conscious decision to act in breach of duty. For the test to be satisfied on grounds of recklessness, at least a suspicion of acting in breach is required. As there was no support in the evidence for the contention that the directors had had the requisite conscious appreciation that they might be breaching their duty, the claim against them failed and their appeal was allowed. For further analysis see our published report and commentary on the decision.

Status of redeeming investors

The status of redeeming hedge fund investors was addressed by the Cayman Islands Grand Court in *Primeo Fund (in liquidation) v. Herald Fund SPC (in liquidation)* (Grand Court, FSD 27/2013, 12 June 2015, unreported). The Court analysed the provisions of section 37(7) of the Companies Law, which deals with the status of redeemable shares in a liquidation and subordinates claims in respect of redemption to outside creditors. It was held that the subsection only applies in cases in which a company's shares are 'to be redeemed,' for example on a fixed date, or in the case of shares which are 'liable to be redeemed,' for example, where a valid redemption notice has been served but the steps required by the articles of association to be undertaken in order to complete the process of redemption have not been completed prior to the commencement of the liquidation. Shares that have already been redeemed pursuant to the company's articles fall outside section 37(7) and are to be treated as ordinary creditor liabilities, with the effect in this case that the redeeming feeder fund was held to rank alongside, rather than behind, other creditors in the winding up.

The ability of a Cayman liquidator to resolve the issue of 'false profits' arising from a Ponzi scheme was also addressed in this case and this aspect of the decision is reviewed in our separate insolvency & restructuring update. For a more detailed review, see our eAlert on the case.

We reported last year on the decision of the Grand Court of the Cayman Islands in the *DD Growth* case, involving the question of whether a payment made by a company out of its own share premium account to redeem its own redeemable shares was a payment out of 'capital' under section 37(6) of the Cayman Islands Companies Law. This was a case where the liquidators of Cayman Islands feeder fund DD Growth Premium 2X Fund were seeking to claw back redemption payments made to RMF before the fund's collapse. It was subsequently shown that the fund was insolvent at the time that the payments were made. On appeal, the liquidators argued that the court at first instance had erred in concluding that such payments did not fall within the solvency requirement in section 37(6)(a) of the Companies Law. The Court of Appeal, in dismissing the appeal, held that payments out of share premium for the redemption or purchase of its own shares are not payments out of capital and are not subject to any solvency requirement: *DD Growth Premium 2X Fund (in official liquidation) v. RMF Market Neutral Strategies (Master) Limited* (Court of Appeal, CICA 24/2014, 20 November 2014, unreported). A further appeal to the Privy Council is anticipated.

Application of 'just and equitable winding up' principles to funds

It is well established in most common law jurisdictions that a company can be wound up where it is 'just and equitable' to do so, and that this will be the case where the company has 'lost its substratum' for existence. The question of what this concept entails in the specific context of an open-ended mutual fund has exercised the courts of Cayman and BVI in particular in recent years, with a fine distinction emerging as to whether it must be 'impossible' or merely 'impractical' for the company to carry on its business in order to invoke this principle. The decision of Clifford, J. in *Re Harbinger Class PE Holdings (Cayman) Ltd* (Grand Court, FSD 80/2015, 10 November 2015, unreported) confirms that the traditional 'impossibility' test for loss of substratum will be applied in the context of any Cayman Islands company that is not an open-ended mutual fund. The Court distinguished the earlier decision of Jones, J. in *In the Matter of Belmont Asset Based Lending Limited* [2010] 1 CILR 83, in effect confining its reasoning to open-ended mutual funds. Whether this marks the start of a change in that particular context as well, remains to be seen. For a more detailed review of the case, see our eAlert which is available here.

Side Letters

In the matter of Lancelot Investors Fund, Ltd (in official liquidation), KBC Investments Limited v. Geoffrey Varga (CICA 27/2013, 27 April 2015, unreported), was a case where the beneficial owner of shares in a fund had sought to vary the lock-up period for redemptions stated in the Fund's Confidential Information Memorandum by entering into a side letter directly with the investment manager of the fund. Efforts by the investor to enforce the side letter were rejected by the Grand Court, which found that the side letter was not enforceable for lack of authority on the part of both the beneficial owner and the investment manager. While the appeal from this decision was unsuccessful on the application of agency and contact law principles relevant to the investment manager's legal authority, the Court of Appeal accepted that in certain circumstances a beneficial owner could directly enforce a side letter attaching rights to its beneficially owned shares, notwithstanding that the custodial shareholder was not party to the agreement. We discuss this decision in more detail in our eAlert, available here.

Management fees and NAV determinations

The Bermuda case of *Kingate Global v. Kingate Management* [2015] SC (Bda) 65 Com, 25 September 2015, unreported, was a trial of various preliminary issues involving one of several feeder funds that had invested in funds run by Bernard Madoff in what has infamously emerged to have been a Ponzi scheme. In particular, the fund's liquidators sought restitution on the grounds of unjust enrichment, of management fees paid to the fund's manager on the basis of NAV calculations that turned out to be false. The court accordingly had to consider provisions in the fund's documents regarding the status of NAV calculations, when they are final and binding and when they may be set aside for fraud or manifest error.

Having found that it was an express term of the manager agreements in question that the monthly NAV determinations by the Administrator for the purposes of the subscription and redemption of shares were to be used to calculate the monthly management fees, the Court was satisfied that there was no contractual term that these determinations were merely provisional and open to correction if later found to be inaccurate. Neither was there any implied term to that effect as that is not what the instrument, read as a whole against the relevant background, would reasonably have been understood to mean. In the absence of bad faith or manifest error the management fees paid to the fund's manager were therefore properly due under the terms of the manager agreements.

The case is also noteworthy in its discussion of the principles of manifest error, mistake and breach of duty in the context of an unjust enrichment claim. Having considered seven preliminary issues, Hellman, J. concluded that in order to succeed on a mistake based claim the Plaintiffs must first establish fault on the part of the Administrator or the fund manager. Absent such fault, the Defendants were contractually entitled to the fees and such entitlement would preclude any claim for unjust enrichment.

Claims against fund managers

The BVI case of *Lin Chee Keen v. FAM Capital Management Limited* (BVIHCMAP 0002/2015, 4 December 2015, unreported) is of interest in the fund context both for its findings in relation to whether a conspiracy claim may be brought against fund promoters or managers and for its findings on the appropriate forum for claims. It was a decision of the Eastern Caribbean Court of Appeal on an appeal against the striking out by Bannister J of claims in conspiracy against the promoters of an investment fund. Bannister, J. had found that "as a matter of law, pleading and common sense" the claim was bound to fail. The Court of Appeal overturned his finding that a conspiracy could not be formed between a company and its agent, relying in part on a Singaporean decision (*Lim Huat v. Chip Hup Hup Kee Construction* [2009] 2 SLR 318). However, the Court accepted that Bannister, J. was nevertheless right to find that the claim was not one which could succeed since the claim was, at its highest level, in respect of nothing more than an investment in an illiquid real estate development where those in charge took a contractually agreed performance fee. The Court also agreed that the BVI was not the proper forum, notwithstanding the fact that some defendants were BVI companies, on the grounds that the main parties were based in Singapore and the underlying events all occurred in Singapore.

Appleby represented the Joint Official Liquidators in DD Growth Premium 2X Fund (in official liquidation) v. RMF Market Neutral Strategies (Master) Limited and the Respondent company in Lin Chee Keen v. FAM Capital Management Limited.

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