No solvency test for payment of redemptions from Cayman Funds?

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No solvency test for payment of redemptions from Cayman Funds?

2014 was a year of significant judgments in the area of claw-back claims. Further clarification has been received recently as to whether, and in what circumstances, liquidators can recover from fund shareholders redemption proceeds paid prior to revelations of massive frauds (usually Ponzi Schemes uncovered in the wake of the 2008 financial crisis). The question whether such claims will succeed is now, in light of the decisions over the last 12 months, more likely to be answered in the negative, which will provide considerable comfort to those concerned about exposure to claw-back action.

In *RMF Market Neutral Strategies (Master) Limited* (**RMF**) *v DD Growth Premium 2X Fund (in Official Liquidation)* (DD) [1] of the Cayman Islands Grand Court, the Chief Justice considered claims by Cayman liquidators to claw-back redemption proceeds paid to investors, on the basis that the payments were:

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RMF was one of seven investors who had submitted valid requests for the redemption of their shares from DD for a redemption date of 31 December 2008. It was not in issue that the redemption requests were all valid and had been accepted by DD.

Although DD was found by the Court to be insolvent on both a cash flow and balance sheet basis at the time that the redemption payments to RMF were made, and although only some of the

redeemers received payment, the liquidators' claims for a claw-back of the payments to RMF were unsuccessful.

Under the Cayman Islands Companies Law (the **Law**), share premium (i.e. the amount by which the issue price of a company's share exceeds its nominal or par value) does not form part of the capital of the fund (unlike in England & Wales). Under section 37(6)(a) of the Law it is unlawful to pay redemptions out of capital if, immediately following the payment, the fund is insolvent (i.e. unable to pay its debts as they fall due in the ordinary course of business). The Court undertook an extensive review of the capital maintenance doctrine as set out in the Law and confirmed that share premium is not 'capital' for the purposes of section 37(6)(a) and therefore the redemption payments made to RMF from share premium (as is extremely common for Cayman investment funds) were not unlawful [2].

It was also held that payment of the redemption proceeds to some redeemers but not others did not constitute an unlawful preference. Whilst RMF was clearly paid ahead of the three unpaid redeemers, the liquidators had not established that it was the "*dominant intention*" of DD's management to prefer RMF over other investors. Interestingly, the Court found that the reason why RMF was paid instead of the unpaid redeemers was in fact due to the "*unrelenting and escalating pressure*" applied by the principals of RMF, on DD's principal, and his desire to buy more time to somehow recover from the Fund's hopelessly insolvent position.

In the judgment, the Court referred to and drew support from the recent decision of the Privy Council in *Fairfield Sentry*[3], in which the liquidators of a BVI investment fund were not entitled to claw back redemption payments made before the Madoff Ponzi scheme fraud came to light, by reason of the fact that the fund was bound by the published and certified NAV on which redeeming investors relied. However, it is not clear that the decision in *Fairfield Sentry* actually provides such support - the Privy Council's remarks in *Fairfield Sentry* related to the position of unredeemed investors *vis a vis* redeemed investors, not the position of redeemed investors *inter se* as in *RMF*.

There are a number of surprising aspects to the *RMF* decision:

One obvious implication of the decision in *RMF* is that a "he who shouts loudest…[gets paid]" principle may now apply, and that there is nothing to stop an insolvent fund satisfying some redemption requests over others. If there is no need to pro-rate payments to redeemers of illiquid funds then investors may well be incentivised to exert pressure to get to the front of the line. Some funds' gating provisions (not in the case of DD) ensure that requests will be pro-rated; but where such provisions are not in place it is possible for funds to take a pragmatic approach to the payment of their redeeming investors, and the only remedy available to a small investor to ensure a pro-rata distribution is made, would now appear to be a petition to have liquidators appointed.

The decision in *RMF* is not the final word on claw-back claims in the Cayman Islands. Other similar claims brought by liquidators are ongoing. Undeterred, the DD liquidators have appealed the judgment (although it is unclear on what grounds) and commenced a number of fresh claw-back actions on 10 December 2014.

The case of *Palm Beach Offshore Ltd (In Official Liquidation)* (25 November 2014), involved a fund exposed to the Petters' Ponzi Scheme. The case is of interest because it suggests that the finding in RMF is considered by some to be relevant to the position of redeemed investors in the context of a winding up. In *Palm Beach* liquidators had rejected a proof of debt by a redeemed investor on the basis that it was unenforceable under section 37(7)(a)(ii) of the Law because the company could not, at any time during the period between the date of the redemption and the date on which the liquidation commenced, have lawfully made a distribution equal in value to the redemption price because it was insolvent at that time. This argument relied on the effect of section 34(2) and / or section 37(6), the effect of which is that a distribution to shareholders is unlawful if, immediately following the payment, the company would be unable to pay its debts as they fall due. However that argument was abandoned as a consequence of the decision in RMF released two days before the hearing took place. The reason given was that the plaintiff's understanding of the RMF decision was that "*a redemption payment out of share premium or capital would be lawful, irrespective of the company's solvency at the time of the payment, provided only that the payment was authorised by the articles.*"

It is surprising that an argument based on section 37(7)(a)(ii) of the Law was abandoned because the *RMF* judgment does not specifically consider that subsection, and section 37(7) is not impacted by the decision in *RMF*. As stated above, section 37(7)(a)(ii) relates to the circumstances in which a redeemed investor may enforce its right to payment against the company in a winding up, and provides that the right may not be enforced if during the period the redemption was to have taken place the company could not lawfully have made a distribution equal in value to the redemption price. This use of the term "distribution" takes 37(7)(a)(ii) outside the remit of the decision in DD, which drew a clear distinction between distributions and redemptions. It appears to remain open to a liquidator to argue that if the fund would be unable to pay its debts as they fall due when the redemption payment was due, the effect of 34(2) and 37(7) is that the redeemed investor could not enforce its right against the company in a winding up.

It is of interest that the Court in *Palm Beach* is also due to consider arguments concerning the statutory power to rectify the register where shareholders have been redeemed on the basis of an overstated NAV. Clawback claims have also been issued by the liquidators of the Weavering Macro Fixed Income Fund Limited; and so it is clear there are several more battles to be fought in Cayman in this particular arena in 2015.

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[1] 17 November 2014

[2] Surprisingly reference was not made during the analysis to the English Court of Appeal's decision in HMRC v First Nationwide [2012] EWCA Civ 278 which found as a matter of fact that share premium was not capital for the purposes of the capital maintenance rules.

[3]Fairfield Sentry Limited (in liquidation) v Migani & ors [2014] UKPC 9

[4]See Segoes Services Limited (in Liquidation) v Oeoka, Kaweski and Highland Consulting Limited [2006] CILR Note 1; and In re M Kushler [1943] 1 Ch. 248

[5]England has also watered down the dominant intention to prefer test by enactment of section 229(5) of the Insolvency Act 1986, where in order for a transaction to amount to being an unlawful preference, the decision to pay a particular creditor must have been made "with a view to giving such creditor…a preference over the other creditors" and being "influenced by a desire to put (such creditor) in a better position than he would have been in in the event of insolvent liquidation";

[6]The rights of creditors become paramount to those of members when a company becomes insolvent West Mercia Safetywear v Dodd [1988] BCLC 250

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